Postal Regulatory Commission
Submitted 3/1/2018 4:21:36 PM
Filing ID: 104026
Accepted 3/1/2018

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

STATUTORY REVIEW OF THE SYSTEM FOR REGULATING RATES AND CLASSES FOR MARKET-DOMINANT PRODUCTS

Docket No. RM2017-3

INITIAL COMMENTS OF THE UNITED STATES POSTAL SERVICE IN RESPONSE TO ORDER NO. 4258

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March 1, 2018

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I. INTRODUCTION

A. Statement of Position

As the Commission correctly recognizes, the current price cap system is not working. The system is too rigid and does not account for market realities that caused revenues to fall far below costs in the PAEA's first decade. The same market realities will continue to impede the Postal Service's ability to obtain financial stability in the short, medium, and long term. This lack of financial stability brings with it additional harms to the entire postal system, including by constraining the Postal Service's ability to invest in modernizing its network. Nevertheless, rather than consider effective non-cap regulatory models, as advocated by the Postal Service, the Commission instead proposes to maintain the current system, albeit with an attempt to address the non-compensatory nature of the Postal Service's rates through a partial, phased recalibration of rates, and with the theoretical potential for some additional non-bankable rate authority. That proposal does not address the fundamental rigidities that doomed the current system, however. By maintaining a price-cap-based system, particularly as currently proposed, the Commission is all but ensuring that the system proposed in Order No. 4258 will fail to meet the statutory objectives, just as the current system did.

The Postal Service firmly believes that the Commission should recognize that a price cap system is wholly unsuited to the demands of the current postal marketplace. Rather, heavy market pressures inherently incent the Postal Service to make prudent pricing decisions, and to pursue cost savings and efficiency gains. These incentives, in combination with robust regulatory monitoring and the threat of regulatory re-intervention, are the best guarantee of achieving the statutory objectives. The Postal

Service is in the best position to evaluate and respond to mailers' pricing and product needs, if given the flexibility to make appropriate business decisions. Because that flexibility will inevitably be constrained by market forces and other conditions, the current price cap's rigidities, which the Commission's proposal would retain, are unnecessary. Greater flexibility would also allow the Postal Service to plan with greater certainty, thereby enabling it to provide more detailed forward guidance to mailers regarding the timing and magnitude of rate increases. Unlike the current system or the Commission's proposal, such a system would meet every statutory objective.

If the Commission is unwilling to adopt such a system, and is instead committed to proceeding with a price cap model for now, the modifications proposed in Order No. 4258 would not actually achieve the goals articulated by the Commission. The current proposal requires some significant adjustments to give the Postal Service a meaningful opportunity to progress toward and ultimately achieve financial stability.

Under either approach (a system with pricing flexibility, regulatory monitoring, and forward guidance, or an updated price cap system that gives the Postal Service a meaningful opportunity at financial stability), the Postal Service will necessarily make appropriate business decisions regarding price levels that will be constrained by market conditions and business realities. The request for increased pricing <u>authority</u>, either within or outside of a price cap system, does not necessarily mean that actual pricing <u>decisions</u> will utilize all such authority. Rather, the focus in this proceeding must remain on authorizing enough flexibility for the Postal Service to respond to customers' short-term and long-term needs, consistent with the Commission's fundamental obligation to confer sufficient pricing authority to restore financial stability and achieve the other objectives.

B. Overview of Comments

As explained in section II, Order No. 4257 provides a largely accurate summary of the current system's failings. Most significantly, the system is not providing meaningful financial stability. The Commission further recognizes, appropriately, that it has the statutory power to change the price cap system. The analysis and conclusions in Order No. 4257, however, fall short in other respects. For example, the Commission's determination that the Postal Service has achieved "short term stability" does not account for the fact that recent, marginally positive liquidity levels are overstated, as they do not reflect unpaid, overdue expenses. The "short-term stability" determination also ignores the Commission's recently confirmed contrary findings about the Postal Service's poor short-term financial health.

As discussed in section III, Order No. 4258 does not justify the retention of a price cap, in light of more effective alternatives. In particular, the Commission fails to explain its claim that objective 2 necessitates a price cap. This assertion is inconsistent with the statute's express contemplation that non-price-cap alternatives can be "necessary to achieve the objectives," as well as with the Commission's own interpretation of objective 2. Ultimately, the Commission has fallen well short of explaining why the Postal Service's proposal is not a preferable approach to an amended price cap for achieving the statutory objectives, particularly in light of empirical examples of successful implementation of comparable systems by other modern postal regulators.

Sections IV and V highlight some of the specific shortcomings of the Commission's proposal related to supplemental pricing authority and performance-based pricing authority, in the event that the Commission is committed to continuing with a price-cap-based system. The Postal Service recommends specific adjustments to the proposal that align with the principles underlying price cap systems generally and that seek to provide a meaningful opportunity for the Postal Service, in conjunction with available cost savings opportunities, to cover its total costs (the Commission's view of "medium-term stability") and to earn surplus revenue than can be used for capital investments (the Commission's view of "long-term stability").

According to Order No. 4258, the proposed supplemental rate authority is intended to put the Postal Service on the path to "medium-term stability," defined as having the opportunity to generate sufficient revenue to cover its obligations. However, section IV explains that the proposal provides an insufficient amount of supplemental authority to achieve this goal for two significant reasons. First, the additional revenue that the 2 percentage points of pricing authority is designed to raise is based on an unrealistic assessment of the Postal Service's baseline net losses. Second, the proposal perpetuates the current system's rigidity by not accounting for volume and cost trends outside of the Postal Service's control that will cause that net-loss baseline to grow in the future.

These flaws are exacerbated by the lack of consideration of how much cost-cutting potential is actually available to the Postal Service. Consequently, the Commission's proposal does not reasonably account for the amount of supplemental revenue necessary to ensure cost coverage. While the Postal Service has a clear duty to continue to aggressively pursue cost savings and efficiency improvements in those areas within its control, its available opportunities are necessarily limited by the statutory constraints under which it operates. Indeed, in Order No. 4257, the Commission recognized those constraints, including the Postal Service's obligation to provide postal services consistent with the policies of title 39; the collective bargaining process that, in cases of impasse, results in binding arbitration; and the Postal Service's pension and retiree health benefits funding obligations. The Commission's reliance on generic cost-cutting as an all-purpose makeweight in Order No. 4258 ignores these constraints and the only record evidence that quantifies the potential for cost savings. That empirical evidence makes clear that the opportunities are far too limited to fill the gaps in the Commission's proposal.

Fixing the supplemental rate authority proposal begins with selecting a more appropriate net-loss baseline. The Commission's proposed baseline is a net loss of $2.7 billion for FY2017, but that figure is unrepresentatively low because of a $2.2 billion non-cash accounting change. The reported net loss is therefore not relevant to the purpose of setting a rate level that reflects reasonable expectations of financial performance in the years ahead. More representative and realistic options abound. The Commission could set the supplemental rate authority by reference to the Postal Service's actual losses in FY2017 (net of the non-cash accounting change), the Postal Service's projected loss for FY2018, or the average annual loss over the preceding five-year period, with or without reasonable adjustments. Ultimately, the most appropriate choice would be to use a net-loss baseline of $6.0 billion for purposes of setting the supplemental rate authority, which would result in supplemental authority of 4 percentage points rather than 2 percentage points per year over five years.

Readjusting rates according to a reasonable baseline is a necessary step toward affording the Postal Service a meaningful opportunity to cover its costs, but it is not itself sufficient because it does not solve the primary reason why the current system failed. To solve that problem, the Commission should also create a mechanism to adjust available rate authority for known factors outside the Postal Service's control that affect its financial stability. These include mail-volume decline, changes in the mail mix, delivery network growth, and fluctuations in pension and retiree health benefits costs. These factors each contributed to the failure of the current system, and unless the new system accounts for them, they will ensure the failure of that system as well.

Section V identifies the shortcomings of the proposed performance-based rate authority. The Commission explains that the purpose of the performance-based rate authority is to permit the Postal Service entry to a "harmonious cycle": surplus revenues allow the Postal Service to accelerate capital investments that increase operational efficiency and maintain service quality, which, in turn, might lead to further increased revenues for more investment. Despite the premise that additional revenue is needed to <u>start</u> the stalled "harmonious cycle" and improve efficiency, the Commission's proposal would provide additional revenue only <u>after</u> efficiency has improved. Instead, the Commission should provide the additional authority for needed capital investment unconditionally, consistent with regulatory practice. Alternatively, if the Commission insists on maintaining the proposed framework, it must make adjustments for the operational-efficiency-based rate authority to be achievable. As currently proposed, that authority will remain out of reach to the Postal Service indefinitely, defeating its intended purpose.

Sections VI and VII offer additional, specific recommendations for improving the Commission's current proposal. Section VI addresses practical concerns about the proposed rules, including providing the Postal Service the authority to bank more than just the inflation-based authority, adjusting the provisions related to the timing of price changes, and making pragmatic changes with respect to the proposed underwater-product rules.[1]

Section VII identifies pricing-related issues in the existing rules, the correction of which would complement the proposal. Namely, the Commission should take this opportunity to exclude inbound international products from the price cap, to stop counting negotiated service agreement volumes against separate, capped products, and to provide the Postal Service with an opportunity to modernize the mail classification system. As to the last point, the Postal Service specifically requests that the Commission provide a procedural mechanism for the Postal Service to propose the restructuring and modernization of mail classifications to allow the product and pricing structure to better reflect the characteristics of the current marketplace.

Filed with these comments are two appendices. Appendix A contains two charts projecting the Postal Service's losses and liquidity over five years, assuming the continuation of the current system or, alternatively, the addition of 2 percentage points of supplemental rate authority. This appendix is an update of Appendix G to the Postal

[1] For brevity's sake, "underwater products/classes" will be used as shorthand for "non-compensatory products/classes" or "products/classes for which attributable costs exceed revenues" in these comments.

Service's March 20, 2017, comments in this proceeding. Like that earlier appendix, it is being filed non-publicly.[2] Appendix B shows the derivation of certain net loss and supplemental rate authority figures discussed in section IV.

II. THE COMMISSION IDENTIFIES MANY OF THE CURRENT SYSTEM'S PROBLEMS, BUT SEVERAL AREAS CALL FOR MORE ROBUST ANALYSIS OF THE OBJECTIVES

A. The Commission Focused on Several of the Key Problems with the Current Price Cap System in Correctly Determining That the Current System Is Not Working

Although it does not capture all of the ways in which the current price cap system fails to meet the statutory objectives (taking into account the relevant factors),[3] Order No. 4257 is largely accurate in its summary of the system's failings.

As the Commission recognizes, the current system has clearly failed in important objectives. It has failed to provide financial stability in any meaningful sense.[4] If nothing else, the objective of "adequate revenues, including retained earnings, to maintain financial stability" (objective 5) clearly inheres a fair opportunity for positive net income and retained earnings, and the current system has not allowed the Postal Service to come close to achieving either, despite the Postal Service's extensive efforts to reduce costs and increase efficiency within its statutory constraints.[5] The

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[2] The Postal Service's application for non-public treatment of the earlier Appendix G applies equally to the current Appendix A, and that application is hereby incorporated by reference into this filing.

[3] *See* Comments of the United States Postal Service, PRC Docket No. RM2017-3 (Mar. 20, 2017) [hereinafter "USPS March 20 Comments"], at 82-138. *See also* section II.C *infra*.

[4] For a discussion of the Commission's "short-term financial stability" analysis, see section II.C.1 below.

[5] Order No. 4257 at 148, 165-71. The Commission appropriately rejects arguments that it should use hypotheses about the total market value of the Postal Service's real estate assets in assessing the financial stability objective. Such speculation is clearly immaterial to this analysis, considering statutory accounting requirements and the Postal Service's operational need for that real estate. *Id.* at 155. *See also* 39 U.S.C. § 2002(a)(1) (requiring Postal Service assets to be "valued at original cost less depreciation"). Of course, Section 2002 is a "polic[y] of this title" that factor 14 requires the Commission

Commission rightly draws on regulatory practice to interpret "just and reasonable rates" (objective 8) as meaning rates that are compensatory but not excessive: it is obvious that the current system's rates have not been excessive, but they also have not been "reasonable" in terms of sustaining the Postal Service's financial stability.[6] In light of these two failed objectives, the current system is clearly contrary to Title 39's "central purpose . . . to place the Postal Service on a self-sufficient basis,"[7] a purpose reaffirmed by the PAEA.

The Commission also rightly articulates the larger harms to the entire postal system that result from a lack of financial stability. In addition to being unable to fulfill statutory funding obligations necessary to ensure post-retirement benefits into the future, the Postal Service is unable to adequately invest in modernizing its network.[8]

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to take into account. The use of original cost (less depreciation), rather than speculative market values, is consistent with longstanding postal regulatory precedent, as well as the uniform practice of other federal rate regulators. Op. & Rec. Dec., PRC Docket No. R90-1 (Jan. 4, 1991), at ¶¶ 3256-3262; Op. & Rec. Dec., PRC Docket No. R87-1 (Mar. 4, 1988), at ¶ 2105; Op. & Rec. Dec., PRC Docket No. R77-1 (May 12, 1978), at 51 & fn.1). *See also* 18 C.F.R. parts 101, 201, 352, 367 (Federal Energy Regulatory Commission (FERC)); 47 C.F.R. §§ 32.2000(b), .2001-.2003, .2111 *et seq.* (Federal Communications Commission (FCC)); 49 C.F.R. part 1201, Instruction 2-1(a) (Surface Transportation Board); Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, 9 F.C.C.R. 4527, at ¶¶ 37, 41-67 (Mar. 30, 1994) (requiring cable providers to value property assets at original cost, rather than market value at time of acquisition, replacement cost, or current "fair value," and noting the FCC's "policy in recent years to bring its regulatory accounting into conformance with [generally accepted accounting principles] as far as possible"). Although the FCC allows fair market value adjustments in limited cases, 47 C.F.R. § 32.2005, those adjustments are used to increase a carrier's rate base and justify higher rates: the opposite result from what market-valuation proponents desire here. *See Illinois Bell Tel. Co. v. FCC*, 911 F.2d 776, 784-85 (D.C. Cir. 1990); Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, 7 F.C.C.R. 296, at ¶¶ 15-18 (Oct. 31, 1991). And the FCC's approach reflects a multi-firm environment with a market for secondhand telecommunications plant assets that is presumably more active than the single-provider mail-delivery environment.

[6] Order No. 4257 at 47-48, 113-19, 226, 228, 230-36; *see* USPS March 20 Comments at 46-47, 82-83, 107-20.

[7] *Direct Mail Advertising Ass'n v. USPS*, 458 F.2d 813, 817 (D.C. Cir. 1972).

[8] *See* Order No. 4257 at 157-58 (citing 39 U.S.C. § 1005(d)(1) and (f)). It is worth nothing that, with respect to its financial stability analysis, the Commission appropriately articulates multiple valid reasons why the Postal Service's post-retirement benefits obligations must be included in any analysis of financial

This lack of sufficient investment curtails the Postal Service's potential for operational efficiency gains and service improvements, which may eventually hamper the Postal Service's ability to retain volume.[9] This basic dynamic and the potential for a vicious cycle have long been recognized in postal regulatory practice.[10]

Finally, the Commission appropriately gives no credence to the "last rate case" myth.[11] The Commission itself strongly encouraged the Postal Service to implement the new PAEA rate system immediately rather than filing a last rate case.[12] Moreover,

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stability: the plain language of objective 5, which refers to retained earnings; the need to account for other statutory policies under factor 14; and Congress's enactment of the current RHB and Civil Service Retirement System (CSRS) funding scheme simultaneously with Section 3622. *Id.* at 157-59. In addition to the precedent that the Commission cites regarding its past analytical practice, considering such obligations in the financial stability analysis is consistent with Commission precedent and case-law about the need to regulate on the basis of current law, rather than on speculation about hypothetical reforms. *Id.* at 158.

[9] Order No. 4258 at 46-53.

[10] Op. & Rec. Dec., PRC Docket No. R94-1 (Nov. 30, 1994), at ¶ 2090 ("Another reason for avoiding chronic operating deficits is their tendency to lead to inefficient operations. The need to avoid exacerbating an already poor financial situation may cause the underfunding of needed activities such as maintenance, new programs, and capital expenditures. Chronic deficits tend to eliminate the operating flexibility that a well-run business must have. . . . In the event that volume growth stops or slows precipitously, large negative equity may mean that the Service lacks the financial resources necessary to adjust to its changed circumstances.").

[11] To be fair, neither did any significant commenter. Of the two commenters to acknowledge the Postal Service's decision not to file a transitional rate case under Section 3622(f), one pointed out that such a rate case would not have anticipated the Great Recession and the subsequent "long-term decline in mail volume." Comment of the National Association of Letter Carriers, AFL-CIO, PRC Docket No. RM2017-3 (Mar. 20, 2017) [hereinafter "NALC March 20 Comments"], at 17. And the other declined to second-guess the decision of actors operating under then-prevailing expectations. Comments of the Public Representative, PRC Docket No. RM2017-3 (Mar. 20, 2017) [hereinafter "Public Representative March 20 Comments"], at 38. A third commenter mentioned the former possibility of "a last cost-of-service rate case under the old rules" to make an unrelated point, without any comment on the merits of the Postal Service's decision. Comments of the Major Mailers Association, the National Association of Presort Mailers, and the National Postal Policy Council, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 22 fn.24.

[12] Order No. 26, Order Proposing Regulations to Establish a System of Ratemaking, Docket No. RM2007-1 (Aug. 15, 2007), at ¶ 1003 ("[The Commission's accelerated implementation of t]he regulations may serve as a safety valve, providing an immediate means to address challenges faced by the Postal Service and perhaps obviate the necessity for rate relief through an omnibus rate case under existing procedures. . . . It would be unfortunate if, in this reformed environment, rate changes had to be litigated under the old cost of service system."). *See also Implementation of the Postal Accountability and Enhancement Act of 2006: Hearing Before the House Subcomm. on Fed. Workforce, Postal Serv., & the District of Columbia*, 110th Cong. 84 (Feb. 28, 2008) (statement of Dan G. Blair, Chairman, Postal Regulatory Commission)

given its timing before any hint of the Great Recession that was to come, the Postal Service had no reason to think that price increases limited to the Consumer Price Index (CPI) would be inadequate. As it turned out, a transitional rate case would have been based on volume assumptions that would prove too rosy, and the Postal Service would have forgone substantial CPI-based price increases in the meantime.[13] The Postal Service would have found itself with far less of a financial cushion going into the Great Recession than it did with early CPI-based price increases. And the inclusion of retiree health benefits (RHB) prefunding obligations in a last rate case would have been offset by the exclusion of other significant payment obligations, likely yielding an even less significant price increase.[14]

Even with the benefit of hindsight, the Commission's calls for the Postal Service to forgo a transitional rate case, and the Postal Service's decision to heed those calls, proved to be the right move. In any case, those decisions are irrelevant to assessing whether the current system achieved the objectives, and the appropriate remedy for correcting the failures of the current system. Thus, the Commission was correct to disregard this argument.

B. The Commission Rightly Identifies Its Statutory Power to Change the Price Cap System

The Commission correctly recognizes that it has the authority to change the current price cap system.[15] As the Commission points out, Section 3622(d)(3)

("Our hard work set the stage for the first rate increase under the PAEA and resulted in the Postal Service foregoing [sic] one final rate case under the old law.").

[13] USPS March 20 Comments at 119-20.

[14] *Id.* at 118-19.

[15] Order No. 4258 at 14-25.

embodies a compromise between the House and Senate's competing visions for modern market-dominant rate regulation. The Senate bill contained a hard CPI price cap, whereas the House envisioned granting the Commission discretion to select the appropriate mode of regulation. The resulting compromise provides that the hard CPI price cap would prevail for the first decade, after which the Commission would get the discretion to modify or replace that system with an "alternative" system. The text of Section 3622(d)(3) clearly says as much,[16] as does Senator Susan Collins's authoritative explanation of the compromise on the Senate floor shortly before passage.[17] To avoid constitutional separation-of-powers problems, Congress cabined the Commission's discretion with nine objectives (and required it to take into account fourteen factors): if anything, this enumeration of parameters arguably provides more, not less, specific guidance than other federal rate regulators' enabling statutes.[18] The Commission's analysis rests on firm footing.

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[16] Section 3622(a) required the Commission to establish a market-dominant rate regulation system following enactment of the PAEA. Section 3622(d)(1)-(2) required that "system" to contain the CPI price cap and certain other features. Section 3622(d)(3) then provided that that very "system" was subject to review and modification or replacement after ten years. If Congress intended that the initial features of the system should remain unchanged, then Section 3622(d)(3) would be surplusage.

[17] 152 Cong. Rec. S11674, S11675 (daily ed. Dec. 8, 2006) (statement of Sen. Collins).

[18] *E.g.*, 16 U.S.C. §§ 824d(a)-(b), 824e(a) (authorizing FERC to determine and fix rates for regulated utilities, which must be "just and reasonable" and not unduly discriminatory or preferential); 47 U.S.C. § 201(b) (requiring rates and classes of FCC-regulated communications services to be "just and reasonable," and allowing the FCC to "prescribe such rules and regulations as may be necessary in the public interest").

C. A Credible Evaluation of the Statutory Objectives Requires Fuller Qualitative Analysis in Some Areas

In a few important areas, however, Order No. 4257 falls short of justifying the Commission's conclusions about whether and how the current system has failed.[19]

1. "Short-term stability" has no place in determining achievement of objective 5

The "short-term financial stability" concept has neither legal significance nor determinative relevance. The Commission says it measures "short-term stability" by analyzing the Postal Service's "operating profit" adjusted "to reflect additional funds available to the Postal Service."[20] It defines "operating profit" to mean "operating revenue" minus "operating expenses," with "operating expenses" being total costs minus interest expense and "accruals for payments to the [RHB Fund], non-cash workers' compensation, and supplemental contribution to the [Federal Employees' Retirement System (FERS)] annuity."[21] This formulation leads the Commission to compute "a positive adjusted operating profit," which, in the Commission's view, establishes the presence of "short-term financial stability" insofar as the Postal Service operated "without service interruption."[22] Whatever its intuitive appeal, this conclusion is inconsistent with objective 5.

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[19] While the discussion in this section is nominally aimed at the Commission's analytical approach in Order No. 4257, the shortcomings in the Commission's analysis are relevant not only to future retrospective reviews, but also to the remedies proposed in Order No. 4258. *See* Order No. 4397, Order Denying Motion for Issuance of Information Request, PRC Docket No. RM2017-3 (Feb. 6, 2018), at 5.

[20] Order No. 4257 at 159.

[21] *Id.* at 159-62 & fn.263.

[22] *Id. at* 165.

With its reference to "adequate revenues, <u>including retained earnings</u>, to maintain financial stability," and its placement within a statutory scheme that dictates many of the Postal Service's costs, objective 5 clearly inheres an expectation that the Postal Service must cover its costs, consistent with the foundational statutory principle that the Postal Service be self-sufficient. Otherwise, it could not generate retained earnings, and that statutory phrase would be surplusage. The Commission aptly recognizes as much.[23] But there is nothing in the text of objective 5 to imply that "financial stability" means the coverage of only some categories of costs and not others.[24] It matters not that the Postal Service has chosen to utilize non-GAAP measures of "controllable income" for its internal financial performance indicators or for public financial reports intended to explain management's performance, or that the Commission has chosen to define "net income without non-operating expenses" for its own purposes. Neither of these measures, which are inherently limited in scope, present a comprehensive measure of financial stability that can justify binding legal determinations as to the achievement of objective 5.[25] At best, such illustrative value

[23] *Id. at* 157-59.

[24] At least as a categorical rule: this is not to say that specific costs cannot be excluded in certain circumstances of inefficient management. *See* USPS March 20 Comments at 55-56, 58-60. However, that is not the basis for the Commission's exclusion of certain costs from the "short term financial stability" analysis. Nor could it be, since those costs are outside the Postal Service's control. *See id.* at 61 ("By focusing on 'incenting' the Postal Service, it is clear that Congress did not intend the objective to be interpreted as calling into question the need for the Postal Service to cover those costs that are ultimately outside of its control: such costs cannot be reduced by more aggressive Postal Service management, no matter how strong the Postal Service's incentives are.") (citing *Pub. Serv. Co. of Indiana v. Interstate Commerce Comm'n*, 749 F.2d 753, 767 (D.C. Cir. 1984) (noting that "factors beyond the control" of the regulated entity do not demonstrate inefficiency)).

[25] The Postal Service presents "controllable income" as a reflection of postal management's operational orientation, not as a measure of financial health, and it cautions that the measure "should not be considered a substitute for net (loss) income and other GAAP reporting measures." *E.g.*, U.S. Postal Serv., FY2017 Form 10-K (2017), at 17 ("In the day-to-day operation of our business, we focus on costs within our control, such as work hours and transportation."). For brevity, these comments will use

might warrant including "controllable income" in the backdrop of illuminating, but ultimately non-determinative, indicators, rather than treating it as a leading player in the objective 5 determination.[26]

The Commission's "controllable income plus available liquidity"[27] measure is also inconsistent with objective 5's requirement of "financial stability." In addition to other conceptual problems,[28] bare reliance on such a measure to indicate "stability" is misleading. As the Commission identifies, the Postal Service has retained its current liquidity only by defaulting on legally mandated payments (or, in a few cases, deferring them pending appeal).[29] Paradoxically, if the Postal Service had complied with those mandates, which the Commission agrees that objective 5 must take into account, it

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"controllable income" as shorthand for this concept, notwithstanding the Commission's different terminology.

[26] Order No. 4257 at 172-75.

[27] *Id.* at 164 ("One of the main drivers of the Postal Service's ability to achieve short-term stability was the availability of the end-of-year cash reserves.").

[28] For instance, there is a dual apples-and-oranges and double-counting problem. Net income (including as adjusted into "controllable income") compares accrued revenue and expenses within a given year. Cash is an asset that accumulates over time as a function of net income and cash flow. By adding end-of-year cash balances to a given year's "controllable income," the Commission effectively double-counts that year's revenue and expenses (as well as the effect of earlier years' net income). Even if the Commission instead used start-of-year cash balances, the problem would remain, as one year's start-of-year balance is merely the prior year's end-of-year balance.

[29] Order No. 4257 at 153 ("The Postal Service had cash reserves despite showing losses every year, primarily because of limited capital investment and nonpayment of the statutory [RHB Fund] payments.").

would not have the very cash that the Commission views as supplying "short-term stability."[30] This is a picture not of stability, but of insolvency.[31]

"Short-term financial stability," in the sense of liquid assets, is a product of net income and retained earnings – the Commission's "medium-" and "long-term financial stability" measures – and not a precursor to them. Once the Postal Service has paid all of its bills, it can take stock of its remaining liquid assets and determine how much is available as a cushion for future uses. At present, the Postal Service does not really have surplus liquid assets; it has past-due but thus-far-uncalled debts to the U.S. Treasury.[32] Only after the Postal Service can earn enough to pay off those short-term liabilities can it start to rebuild true liquidity. As discussed in section IV below, making progress in that direction requires stronger medicine than Order No. 4258 prescribes.

The Commission's reliance on cash reserves (maintained solely through defaults on, or deferrals of, mandatory payments) to justify its "short-term financial stability" conclusion is also at odds with the expert evidence supporting the use of liquidity as a financial stability metric. In its report, Evercore explained that the Commission's

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[30] The FY2007-FY2010 cash balances reflect the fact that cash was used to pay RHB prefunding expenses, and the FY2012-FY2016 cash balances reflect the fact that cash was not so used. (No RHB prefunding payment was due in FY2011.) If the Commission treated the RHB prefunding payments consistently, then one option would be to add the cumulative effect of the RHB payment amounts back to FY2007-FY2016 cash balances, as if the early payments had not been made. However, that would inflate the cash balances to such an unrepresentative and counterfactual degree as to have no realistic bearing on "short-term financial stability." Alternatively, the defaulted RHB prefunding payments could be treated consistently with the earlier payments, with their cumulative impact deducted from the FY2012-FY2016 cash balances, as if the expenses had actually been paid. The likely result is that the Commission's own measure would then indicate a lack of "short-term financial stability."

[31] *See* Motion by the Public Representative for Reconsideration, PRC Docket No. RM2017-3 (Jan. 5, 2018), at 6-7.

[32] If the Postal Service continues to default on short-term liabilities in the interest of keeping cash in its own accounts to ensure fulfillment of its universal service obligation, the pension and RHB funds' assets will be progressively drawn down until they are completely exhausted.

originally exclusive focus on economic profit and operating profit "fails to account for the USPS's ability to weather market fluctuations using liquidity and access to capital."[33] But Evercore did not propose to treat the mere presence of cash reserves as a demonstration of stability in itself, as the Commission essentially does in Order No. 4257. At an extreme, cash reserves amounting to a single day of operating expenses would hardly indicate short-term stability, as the slightest shock could leave the firm without any cash with which to pay bills. At the other extreme, a firm may have enough liquidity to withstand even a long-lasting emergency. The proper question is where the line of "adequate . . . to maintain financial stability" should be drawn: that is, how many days' worth of cash are enough to deem the firm stable. In a robust benchmarking analysis, Evercore explained why it considered federal utilities and foreign postal operators to be more comparable than federally regulated airport operators for this particular purpose.[34] Evercore found that these comparators had an average of 240 theoretical liquidity days of operating expenses, while the Postal Service had only 39.[35] Whether or not the Commission agrees with Evercore's specific comparators, metrics, and findings, Order No. 4257 does not address the question of whether, relative to what similar firms deem appropriate for short-term needs, the Postal Service's liquidity levels

[33] USPS March 20 Comments, appx. B at 18.

[34] *Id.*, appx. B at 44.

[35] *Id.*, appx. B at 44-46. Evercore's "theoretical liquidity" concept accounts for not only firms' current cash and borrowing authority, but also the amount that private firms could theoretically borrow without risking a credit-rating downgrade. *Id.* at 37. *See also* NALC March 20 Comments at 7 ("In 2016, USPS's cash on hand amounted to less than 30 days of operating disbursements. The lack of liquidity makes USPS extremely vulnerable. With such limited cash reserves, USPS would be unable to weather a severe economic downtown or a crisis in the delivery market." (citation omitted)); Comments of the American Postal Workers Union, AFL-CIO, PRC Docket No. RM2017-3 (Mar. 20, 2017) [hereinafter "APWU March 20 Comments"], at 23 ("[T]he Postal Service's controllable net income does not reflect a vibrant financial situation.").

have been "adequate . . . to maintain financial stability."[36] Indeed, they have clearly not been adequate, because those levels have not enabled the Postal Service to sustainably cover its costs.

The approach to "short-term financial stability" in this proceeding, and the Commission's conclusions, are also at odds with the Commission's own past pronouncements, including its approach in the very financial analysis reports from which it purports to draw. For example, while the financial analysis report issued by the Commission during the pendency of this proceeding does report on "operating income" and liquidity (albeit not in combination), it does not purport to use those measures as indicators of short-term financial stability.[37] Rather, the report discusses the Postal Service's "short-term financial health" and "ability to meet its short-term obligations" exclusively in the context of working capital and liquidity-related ratios, which Order No. 4257 inexplicably relegates to mere "Additional Considerations."[38] Unlike the pure

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[36] More generally, the Commission also does not explain how its preferred approach is "the most comprehensive," in light of Evercore's criticism of the proposed short-/medium-/long-term approach as "not provid[ing] a comprehensive view of financial stability." *Compare* Order No. 4257 at 154 *with* USPS March 20 Comments, appx. B at 18. As it stands, the Commission's approach of treating any cash reserves as an indicator of financial stability seems less, not more, comprehensive than an approach that goes further and asks whether liquidity levels are adequate, relative to industry practices. *See* USPS March 20 Comments, appx. B at 48 (explaining the need for qualitative evaluation in addition to quantitative performance measurement). The Commission's sole response to the Evercore report was to add metrics to the non-determinative "Additional Considerations," without addressing its more fundamental criticisms of the determinative metrics. Order No. 4257 at 154. That does not "answer[] objections that on their face seem legitimate." *PSEG Energy Res. & Trade LLC v. FERC*, 665 F.3d 203, 209 (D.C. Cir. 2011) (citations omitted).

[37] Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2016 (Mar. 31, 2017), at 1-2.

[38] *Compare id.* at 77-79, 86, *with* Order No. 4257 at 172-75. "Working capital is the amount by which the value of current assets exceeds current liabilities and is a liquid financial cushion available for emergencies and other unplanned needs." Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2016 (Mar. 31, 2017), at 79. The liquidity-related ratios are the current ratio (current assets divided by current liabilities), the quick ratio (cash, cash equivalents, short-term investments, and current receivables divided by current liabilities), and the cash ratio (cash, cash equivalents, and short-term investments divided by current liabilities). *Id.*

liquidity figures that the Commission used in Order No. 4257, these established measures actually illuminate the question of "adequacy . . . to maintain financial stability," because they measure not only the absolute value of liquid assets but their proportion to short-term obligations.[39] The Commission found that "the Postal Service does not have enough cash and/or cash equivalents (the most liquid assets) to meet all current liabilities."[40] And the Postal Service has had increasingly negative working capital, which translates into no "financial cushion available for emergencies and other unplanned needs" and potential "problems paying back creditors in the short term, ultimately adversely affecting [the Postal Service's] financial position."[41] If the Commission were truly being consistent with its established approach to financial analysis, as it has claimed,[42] it would have given determinative weight to these more meaningful measures, rather than to a novel "controllable income plus available liquidity" hybrid, and it would have found a lack of short-term financial stability.[43]

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[39] *Id. at* 79-80.

[40] *Id.* at 79.

[41] *Id.* at 79-80, 86. *See also Accomplishing Postal Reform in the 115th Congress – H.R. 756, The Postal Service Reform Act of 2017: Hearing Before the House Comm. on Oversight & Gov't Reform*, 115th Cong. at 41 (Feb. 7, 2017) (written statement of Commission Chairman Robert G. Taub) ("If a downturn in the economy or other circumstance should further stress the Postal Service's cash flow, it risks not being able to pay some of its bills and could, in a worst case scenario, run out of cash.").

[42] *See* Order No. 4257 at 153, 160 & fn.263; Order No. 3673 at 7.

[43] Beyond the substantive departure from established practice, there is a technical inconsistency as well. In Order No. 4258, the Commission adjusts operating expenses for interest expense and non-cash accounting changes (such as those concerning the workers' compensation liability), but it does not adjust revenue for interest income or non-cash accounting changes (such as those concerning postage in the hands of the public). Not only is this internally inconsistent, it is also inconsistent with the Commission's approach and findings in the very past financial analyses that it invokes as a model. *Compare* Order No. 4257 at 162 (showing net operating income of $479 million in FY2013 and $1,792 million in FY2016) *with* Postal Regulatory Comm'n, Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2013 (Apr. 10, 2014), at 3 (showing net operating loss of $1,004 million in FY2013, after, among other things, a revenue "[a]djustment for postage related to Forever Stamps"), *and* Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2016 (Mar. 31, 2017), at 1, 6 (showing net operating income of only $610 million

Because the "controllable income plus available liquidity" metric conflicts with the language of the statute, is inconsistent with the record evidence on financial stability, and is contrary to the Commission's established approach to measuring short-term financial health, the Commission should relegate it to an "additional consideration," if the Commission deems it worth including at all. If the Commission does retain a liquidity-based, determinative "short-term stability" metric, then it should undertake a qualitative evaluation of what level of liquidity would be "adequate . . . to maintain financial stability" and assess the system under review and any proposed modification or alternative system on the basis of that "adequate" level.

2. The assessment of operational efficiency and cost reduction is incomplete without qualitative context

The Commission's method of analyzing objective 1 reaches a faulty conclusion by failing to consider necessary context. While the Commission correctly demonstrates that operational efficiency was improved and costs were reduced during the post-PAEA decade,[44] it then states that the Postal Service did not have "maximum" incentives

in FY2016, after, among other things, "any one-time expense or revenue adjustments"). *But see* Order No. 4257 at 160 & fn.263 (claiming that its approach in Order No. 4257 "is consistent with that taken in the Commission's annual financial reports," and that "[o]perating revenue is the revenue generated from mailing products and services"); Order No. 3673 at 7 (referencing the Commission's annual financial analysis as a model for measurement of operating profit).

[44] The Postal Service discussed the relevant efforts at pages 113 to 117 of its March 20 Comments. While the Commission reached the correct conclusion that, according to its "determinative" metrics, costs were reduced and operational efficiency increased in the first post-PAEA decade, "no single metric captures everything that the Postal Service may be doing to reduce costs and increase efficiency, [and so] the Commission should use a range of measures" beyond those metrics to determine whether objective 1 was achieved. USPS March 20 Comments at 56. *See also id.* at 57 ("Moreover, when considering the Postal Service's cost reduction efforts, it is important to comprehensively assess the Postal Service's actual initiatives to reduce costs, and future operational plans, without focusing simply on metrics such as unit operating costs or controllable costs. How those metrics vary over time is subject to a large number of factors that are outside of the Postal Service's control."). Hence, in future reviews, the Commission should ensure that its analysis of objective 1 is based on a comprehensive assessment of the Postal Service's efforts. While the Commission states that objective 1 requires a purely quantitative

because (1) the cost reductions and efficiency improvements were not "sufficient to contribute to the financial stability of the Postal Service"; and (2) the rate by which costs were reduced and efficiency improved did not match that experienced "during the relevant comparable time period" (i.e., the 10 years preceding implementation of the PAEA).[45] However, neither constitutes an appropriate basis to assess the strength of the Postal Service's incentives.

First, the significant efforts by the Postal Service to reduce costs and increase efficiency following the enactment of the PAEA certainly "contribute[d]" to making the Postal Service more financially secure than it otherwise would have been absent such efforts.[46] While it is true that the Postal Service was unable to maintain "financial stability," that fact does not provide a logical reason to conclude that the Postal Service lacked maximum incentives. As the Commission recognizes, the Postal Service is subject to a number of constraints that inhibit its ability to change its costs or improve efficiency, including the universal service obligation, the collective bargaining and interest arbitration process, and the Postal Service's large post-retirement benefit payment obligations.[47] These constraints, as well as the precipitous volume declines,

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rather than dual quantitative and qualitative assessment of efficiency, Order No. 4258 at 204, it is hardly intuitive why that should be the case, and Order No. 4258 provides no further explanation.

[45] Order No. 4257 at 222-26.

[46] USPS March 20 Comments, appx. D at 6 ("Since increases in TFP lead to reductions in resources being used to handle Postal Service workload, those TFP increases also lead to cost reductions and increases in Postal Service net income.").

[47] Order No. 4257 at 198-99, 219. Specifically, with respect to collective bargaining, the Commission appropriately accounts for how the Postal Service's "unique [labor] cost structure," with its system of binding arbitration in cases of bargaining impasse, affects the Postal Service's ability to change its labor costs. *Id.* at 199. Here, the Commission's refusal to disallow allegedly inflated labor costs, as some mailers had requested, is consistent with the plain language of the statute. Pub. L. No. 109-435, § 505(b), 120 Stat. 3198, 3236 (2006) (barring the PAEA from being applied in such a way as to affect labor rights). *See also* USPS March 20 Comments at 70-72 (recounting the legislative history of PAEA

have driven the Postal Service's financial decline.[48] Hence, even if the Postal Service achieves significant reductions in costs and increases efficiency, consistent with having "maximum incentives" to doing so, it may nevertheless lack financial stability due to the costs and volume trends outside of its control.[49]

Second, a simple comparison of pre-PAEA and post-PAEA period trend rates is not a rational basis to draw any conclusions about the strength of the Postal Service's incentives. While it is true that the annual average rate of total factor productivity (TFP) growth and real unit market-dominant attributable cost (RUMDAC) decline were each lower in the PAEA era than in the preceding decade,[50] it is not adequate to stop the analysis at that point, as the Commission does. Rather, these trends are influenced by multiple contextual factors that must be considered in any comparative analysis.

For instance, as Christensen Associates have noted, the exact rate of growth in TFP is subject to a number of factors, including "workload trends, capital investments,

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Section 505(b)). It also conforms to the Commission's longstanding precedent concerning the relationship between its regulatory authority and the collective bargaining process. Op. & Rec. Dec., PRC Docket No. R84-1 (Sept. 7, 1984), at ¶¶ 1145 fn.55, 1150-1151 (recognizing that, "inherently, any estimated test year labor costs recommended by the Commission may have some effect on labor negotiations," and reaffirming that labor cost projections should be "the least possibly intrusive upon the negotiation process"); Op. & Rec. Dec., PRC Docket No. R80-1 (Feb. 19, 1981), at ¶ 187 (approving the Postal Service's approach to estimating labor costs as "the least intrusive into the bargaining process – an area clearly outside the Commission's powers").

[48] Indeed, and consistent with its prior determinations on this subject, the Commission nowhere indicates in Order No. 4257 that the lack of financial stability was the result of the Postal Service's failure to exercise efficient management.

[49] USPS March 20 Comments, appx. D at 1 ("TFP can increase in periods where net income decreases (and *vice versa*) because of other tends facing the Postal Service. One trend that has been important in recent years is the decline in mail volume, particularly among those products that have relatively high markups over attributable costs. Postal Service TFP has increased substantially during the PAEA years even though the Postal Service suffered substantial losses."). *See also id.* at 6-7 (noting that the Postal Service's financial losses "do not reflect poor TFP performance" because cost constraints, revenue constraints, and declining volume "were the driving factors leading to" those losses).

[50] Order No. 4257 at 224-26.

and the ability of the Postal Service to implement initiatives to capture additional savings."[51] In periods of significantly declining workload, it is more difficult to achieve TFP growth, because the necessary level by which the Postal Service must reduce resource usage increases.[52] Of course, workload declined much more significantly during the PAEA period than prior to the PAEA, a factor that is not considered in the Commission's simple comparison.

In addition, TFP growth requires that the Postal Service achieve efficiency gains in addition to those achieved in prior years, and is therefore affected by the extent to which the Postal Service has already increased its efficiency within the constraints of its statutory structure, including the fact that the Postal Service's universal service obligation requires a network of a certain size, scale, and geographic distribution.[53] In this regard, following what the Commission has recognized as significant pre-PAEA TFP gains,[54] as well as the gains achieved after the Great Recession, the potential for further efficiency growth has simply declined over time.

> [A]fter 17 years of substantial efficiency gains and cost reductions, it must be recognized that the ability to achieve <u>additional</u> reduction in those costs that are within the Postal Service's control will be more difficult moving forward. The Postal Service is a labor-intensive organization, and it has been able to drive labor cost savings since the turn of the century primarily through reducing workhours and employee complement. Both of these sources of savings are now more challenging to capture, particularly at the levels previously achieved. For instance, after years of attrition and continuous headcount decline, the Postal Service's complement has grown slightly over the last couple of years as the delivery network grows and the number of packages (which are more costly to deliver) increases. Furthermore, while the cost of current employees has been reduced

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[51] USPS March 20 Comments, appx. D at 9.

[52] *Id.*, appx. D at 7-8.

[53] *Id.*, appx. D at 5-6, 9.

[54] Order No. 4257 at 222-26.

> through factors such as the increase in non-career employees and the imposition of a two-tier career workforce (which will drive significant savings in the future as older employees retire and new employees are hired), the ability to achieve additional reductions in this area is dependent on the outcome of future rounds of collective bargaining. While the Postal Service will continue to pursue favorable outcomes in collective bargaining and interest arbitration, the outcome of that process is inherently uncertain.[55]

The recent downturn in TFP growth attests to the fact that it has become more challenging for the Postal Service to achieve productivity gains. This is validated by the expert evidence in this proceeding regarding the further annual cost savings that remain within management control over the next five years.[56]

Another factor that the Commission recognizes can inhibit productivity growth is a paucity of funds to invest in operational efficiency improvement and cost reduction. Indeed, the TFP and RUMDAC trends in the 2000s reflect the beneficial impact of investments in automation and other efficiency-improving measures during the 1990s and early 2000s, when the ratemaking model in place enabled the Postal Service to make needed capital investments.[57] The more recent TFP/RUMDAC results are therefore not surprising, given that the post-PAEA price cap, in combination with accelerating volume declines, has starved the Postal Service of funds to invest.[58] The

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[55] USPS March 20 Comments at 194-95 (emphasis in original). *See also id.* at 196 ("Finding new ways to reduce cost can, in turn, be more difficult if a firm has already captured significant efficiency gains in prior years, particularly if it is subject to legal constraints that can inhibit its efforts.") (citing *id.*, appx. D at 5-6 & fn.14).

[56] *Id.* at 145-47. *See generally id.*, appx. C.

[57] *See id.*, appx. D at 9 ("While the Postal Service productivity record since 2000 has been commendable, one cannot simply use that performance as a benchmark for future years. . . . Over the past sixteen years, the Postal Service was able to make substantial progress in automating letter processing and mechanizing parcel sortation. These innovations made it possible for the Postal Service to reduce costs and increase TFP.").

[58] While capital investments may constitute a drag on TFP in the short term before their beneficial impact is fully realized (a factor that, as discussed in section V.B.2 below, the Commission fails to appropriately

Commission has long sounded the alarm about insufficient post-PAEA investment as a drag on efficiency,[59] and so it is puzzling that this factor did not appear in Order No. 4257's longitudinal analysis of operational efficiency and cost reductions.

Fundamentally, an assessment of the TFP/RUMDAC trends discussed by the Commission discloses the basic point that factors outside of the specifics of the ratemaking system incentivize the Postal Service to reduce costs and increase efficiency. The Commission's comparison of pre- and post-PAEA TFP trends, analyzed in context, shows that the change in rate-regulation model did not produce any inflection point in TFP growth. Rather, the decline in contribution-weighted volume per delivery point beginning in the early 2000s incented significant productivity growth prior to the PAEA, and the accelerated decline incented further significant productivity growth following the PAEA.[60] Nor is there a material difference in the RUMDAC trends considered by the Commission before and after the enactment of the PAEA. The Commission should recognize the obvious implication of these trends: in the demand environment that has prevailed since the turn of the century, the mode of rate regulation

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take into account in its proposed rules), such investments can eventually help to spur TFP growth. *Id.*, appx. D at 5. In this regard, the Postal Service has been forced to constrain capital investments for years.

[59] *E.g.*, Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2016 (Mar. 31, 2017), at 28 ("In order for the Postal Service to be competitive in today's growing e-commerce market, it will have to increase its capital expenditures."); *Reforming the Postal Service: Finding a Viable Solution: Hearing Before the House Comm. on Oversight & Gov't Reform*, 114th Cong. at 24 (May 11, 2016) (oral statement of Commission Chairman Robert G. Taub) ("Low liquidity levels in recent years have impeded the Postal Service's ability to make capital investments in infrastructure."); *id.* at 32 (written statement of Commission Chairman Taub) ("These low liquidity levels in recent years have impeded the Postal Service's ability to make capital investments in infrastructure and hindered the growth and productivity enhancements in key assets required for primary postal operations."); Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2014 (Apr. 1, 2015), at 2 ("Postal Service liquidity is insufficient to significantly improve operational efficiency.").

[60] USPS March 20 Comments at 124-29.

ultimately has had little to no effect on the Postal Service's practical incentives to reduce costs and increase efficiency, because those incentives exist regardless of the specific mode in place.[61]

In the exercise of its authority, it is of course important for the Commission to recognize and effectuate the goal of the PAEA to ensure that the ratemaking system reflects the Postal Service's legal obligation to continuously pursue cost reductions and efficiency improvements consistent with its statutory responsibilities and constraints.[62] This is reflected in objective 1. At the same time, the evidence from the past two decades discloses the power of exogenous demand declines to incentivize cost reductions and efficiency improvements. The lesson here is that, in the market environment that has prevailed for the last two decades, the Postal Service has strong inherent efficiency incentives, and that the best thing that the rate-regulation system can do is to give the Postal Service the flexibility to make the capital investments and other business decisions necessary to fulfill its universal service mission in an efficient and effective manner.

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[61] Given the Commission's inclination to ascribe pre- and post-PAEA TFP and RUMDAC trend rates to the relative incentive effects of the two ratemaking systems, it is striking that the Commission does not explore why the trend rates were better under the pre-PAEA cost-of-service ratemaking system than under the post-PAEA price cap system. This observation would seem to warrant further qualitative discussion as to whether, in the internet-era market environment, a price cap is truly effective at incentivizing operational efficiency and cost reductions.

[62] As the Postal Service discussed in its March 20 Comments, Congress did not consider this legal obligation to be fully reflected in the pre-PAEA system. USPS March 20 Comments at 37-40.

3. The mere incidence of service standard changes is not *per se* proof that the system failed to allow for the maintenance of "high quality" service standards

Objective 3 requires a system to be "designed to . . . maintain high quality service standards established under section 3691." The statute implies a four-part inquiry:

(1) Were service standards[63] "maintained," or did they change at all during the relevant period?

(2) If they changed, were they "maintained" at a "high quality" level?

(3) If not, is that because of the ratemaking system's "design"?

(4) If so, what is the design flaw, and how should it be fixed? Is the problem insufficient incentives to maintain service, or a failure to provide the means for the Postal Service to respond to incentives, or both?

The Commission's analysis of service standards in Order No. 4257 focuses solely on the first question. As such, it is not enough to support the Commission's conclusion that "the goals of the PAEA with regard to Objective 3 have not been achieved."[64]

The Commission begins, reasonably enough, with a determination that "the initial service standards set in 2007 were 'high quality' service standards," because

> the Postal Service, in consultation with the Commission, designed them to achieve the four objectives of section 3691(b), taking into account the eight factors enumerated in section 3691(c). . . . By cross-referencing the service standards which were to be established under section 3691 and identifying them as "high quality," section 3622(b)(3) makes clear that the outcome of the section 3691 process resulted in service standards that were presumably high quality.[65]

[63] Because the remedy proposed in Order No. 4258 aims at the service standards aspect of objective 3, as interpreted by the Commission, the discussion in this section will likewise focus on service standards, touching only briefly on the service-performance aspect of objective 3.

[64] Order No. 4257 at 273.

[65] *Id.* at 264-65.

The Commission then recounts “two major revisions” to those initial service standards, which “had a substantial impact on the level of service for multiple mail classes.”[66] For example, the Commission considered the elimination of overnight delivery to “cause[ ] a reduction in the quality of service compared to the initial 2007 service standards” for First-Class Mail, Periodicals, Standard Mail, and Package Services.[67] To the Commission, “the decline of service standards during the PAEA era [demonstrated that] the ratemaking system did not effectively encourage the Postal Service to maintain service quality[, which] creates a danger that the Postal Service could reduce service standards below a high quality level required by 39 U.S.C. § 3622(b)(3).”[68]

While it is, of course, true that the Postal Service reduced service standards, that fact only completes the first analytical step involved in objective 3. To conclude that the objective was not achieved, the Commission would then need to find that the resulting service standards were themselves no longer “high quality.” The mere fact of changes is not enough: as the Commission recognizes, 39 U.S.C. § 3691 – which objective 3 emphatically cross-references[69] – allows the Postal Service to change service standards in any manner consistent with the objectives and factors enumerated therein. And while the Commission finds that the 2007 service standards were *per se* “high quality” because they were based on the Postal Service’s application of the 39 U.S.C. § 3691 criteria and process, the Commission does not explain why the same presumption of “high quality” should not equally attach to the 2012-2015 service

[66] *Id.* at 266.

[67] *Id.* at 268.

[68] *Id.* at 269.

[69] Notably, objective 3 is the only objective for which Congress deemed it necessary to expressly cross-reference another PAEA provision.

standard changes, which followed the same criteria and process. Indeed, the Postal Service extensively explained its reasoning why the service standard changes it implemented were consistent with Section 3691, and the Commission never concluded that the revised standards were not "high-quality."[70]

The application of objective 3 in Order No. 4257 is therefore inconsistent with the statute. In revising service standards, the PAEA charges the Postal Service with weighing multiple, largely qualitative objectives and factors, including the current needs of the mailing public and projected volumes, revenues, and operating costs.[71] It cannot be that Congress intended the Postal Service to establish service standards and "from time to time . . . revise" them to reflect changing customer habits and Postal Service finances, while at the same time giving the Commission a silent mandate to frown on any and all "downward" changes, regardless of context. To the contrary,

> [r]educing service levels to account for declining demand for postal services, caused by factors such as electronic diversion and changing demographics, to thereby ensure a better alignment between the costs of the Postal Service's network and available revenues (to be derived from reasonable rates), is fully consistent with the statute, so long as the new service levels still adhere to the standards set forth by Congress.

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[70] Advisory Opinion on Service Changes Associated with Standard Mail Load Leveling, PRC Docket No. N2014-1 (Mar. 26, 2014), at 52-54; Advisory Opinion on Mail Processing Network Rationalization Service Changes, PRC Docket No. N2012-1 (Sept. 28, 2012) [hereinafter "MPNR Advisory Opinion"], at 147-52. In Docket No. N2012-1, the Commission expressly declined to reach any conclusion about the service standard changes' effect on objective 3. MPNR Advisory Opinion at 154 ("The price cap issue [of whether and how the service standard changes at issue in that opinion implicate objective 3] has not been sufficiently developed on this record to support any conclusions, and this issue will not be resolved within the context of an advisory opinion."). If the Commission did not consider the multiple witnesses and ample data on the record in that proceeding to provide a basis for any conclusions about objective 3, it is unclear how the Commission could reach such a conclusion in this one, which yielded no additional evidence about whether the resulting service standards were of "high quality."

[71] 39 U.S.C. § 3691(b)(1)(A)-(D), (c)(1)-(8). In a proceeding shortly after the PAEA, and concurrent with the Postal Service's establishment of its initial "high quality" service standards, the Commission noted strong stakeholder support for "the continued need for the Postal Service's flexibility to adapt its operations to changing conditions while maintaining universal service." Postal Regulatory Comm'n, Report on Universal Postal Service & the Postal Monopoly (Dec. 19, 2008), at 155.

> Particularly given mail volume trends – which necessitate comprehensive action regarding both price and cost in order for the Postal Service to maintain financial stability – it would make no sense for the Commission to interpret the objectives as mandating that the financial benefits of such service level changes must be counteracted by reducing the Postal Service's ability to raise rates.[72]

Such a construction of the statute is particularly questionable in light of Congress's conferral on the Commission of only a limited advisory role in decisions regarding appropriate service standards.[73] Rather than using its Section 3622 authority "in a manner designed to dictate or influence Postal Service decision-making regarding the service standards themselves, or service levels more generally," the Commission should apply the Section 3622 objectives to find a service-based failure only to the extent that, upon qualitative evaluation, the Postal Service's decisions "fall[ ] wholly outside the bounds of efficient management."[74]

In sum, the Commission's analysis of objective 3 covers the necessary first steps of quantitative evaluation of service standard changes. But that is only the first step; objective 3 requires three more. First, objective 3 requires a determination not of whether service standards were "maintained" at their initial level, but at a "high quality" level. That necessarily requires qualitative evaluation of whether the changed service

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[72] USPS March 20 Comments at 75-76.

[73] 39 U.S.C. § 3691(a). *See* USPS March 20 Comments at 76-77.

[74] USPS March 20 Comments at 77. This point applies as much to Postal Service decisions to maintain service levels despite potential efficiency trade-offs, *see id.*, as to decisions to change them. *See also id.* at 222 fn.435 ("[I]t would be wholly irrational to seek to reduce the Postal Service's ability to use price as a tool to address its financial stability because of service level changes or service performance trends. Ultimately, if any post is to survive in the current and future marketplace, it must adapt to the declining demand for the mail by appropriately balancing its costs (derived in significant part by service levels) with its rate levels. . . . Moreover, penalizing service performance issues by denying a post necessary pricing authority [for investing in operational improvement] is . . . counter-productive to improving service.").

standards remain "high quality."[75] The cross-reference to 39 U.S.C. § 3691 underscores the need for qualitative assessment and regulatory modesty, as Section 3691 charges the Postal Service, not the Commission, with the primary role in determining what service levels are appropriate in light of a number of qualitative factors. While the Commission is right to treat Postal Service compliance with 39 U.S.C. § 3691's decision-making guidelines and process as setting a presumption of "high quality," that presumption must be accorded consistently to all service standards so established. If the Commission has a basis to believe that the post-2015 service standards are no longer "high quality" despite the application of the Section 3691 criteria and process, then that basis is not evident from Order No. 4257.

Second and third, objective 3 requires a determination not only that "high quality" service standards were not "maintained," but that that failing is due to a flaw in the design of the system.[76] In this case, if more rigorous qualitative analysis still leads the Commission to conclude that service standards were unduly downgraded between 2012 and 2015 (a determination the Postal Service would strongly disagree with), the Commission must consider what role, if any, the ratemaking system played. Submissions in this proceeding, as well as the Commission's own past pronouncements, clearly link any systemic service shortfalls to the current price cap's unusually harsh austerity, as well as to the resulting lack of capital to invest in

[75] To be fair, at least one Commissioner appreciated the importance of this second inquiry. *See* Order No. 4257, Supp. Views of Comm'r Tony Hammond, at 3 ("I believe the service standards the Postal Service adopted immediately after the PAEA met the objective [of maintaining high quality service standards]. I also believe that the lengthened standards the Postal Service enacted 5 years later continued to meet the objective, although less so.").

[76] 39 U.S.C. § 3622(b) ("Such system shall be designed to achieve the following objectives[.]").

maintaining and improving service quality.[77] The Commission should follow through with its own determination of whether the ratemaking system, through its provision of revenue, was designed to achieve the maintenance of "high quality" service standards.

III. ORDER NO. 4258 DOES NOT JUSTIFY A CONTINUED PRICE CAP IN THE FACE OF THE POSTAL SERVICE'S SIMPLE, DIRECT PROPOSAL

A. The Broad Range of Options Available to the Commission Imposes a Duty to Offer a Reasoned Explanation of Its Choice

With Section 3622(d)(3), Congress gave the Commission broad power to consider and enact alternatives to Congress's initial decision to impose price cap regulation as the successor to the cost-of-service system under the PRA. The initial "system" required a price cap, but as the Commission recognizes, Congress included no such limitation on the range of "alternative systems" available under Section 3622(d)(3).[78] While the same provision allows for smaller-scale "modifications" of the

[77] USPS March 20 Comments at 52-54 (quoting Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2014 (2015), at 23-24; Order No. 1926, Order Granting Exigent Price Increase, PRC Docket No. R2013-11 (Dec. 24, 2013), at 199-22; Op. & Rec. Dec., PRC Docket No. R94-1 (Nov. 30, 1994), at ¶ 20); *id.* at 121-22 & fn.234 (citing Order No. 1926 at 158); Public Representative March 20 Comments at 24-25; APWU March 20 Comments at 10, 17, 24-25; Comments of the News Media Alliance, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 2-3 (hailing the price cap's forcing of cost reductions, including "network rationalization, the closing of many post offices, and the lowering of service standards," but bewailing the service impacts of those same price-cap-driven measures). *See* Public Representative Comments, PRC Docket No. PI2016-3 (June 15, 2016), at 39-41 (attributing the impetus for network rationalization, as well as the service performance results that followed implementation, to "the limitations on Postal Service revenue since the PAEA was passed"). With respect to the service-performance aspect of objective 3, the Commission correctly recognized that the chief obstacle to service quality is the Postal Service's financial situation and resultant lack of capital, and it followed regulatory best practice by opting to continue monitoring service performance. Order No. 4257 at 273; Order No. 4258 at 46-53.

[78] Order No. 4258 at 22-23 ("[Senator Collins's floor] statement also confirms that the congressional sponsors of the PAEA contemplated that the Commission would have broad discretion after the section 3622 review—including deciding whether to continue the price cap in its current form, modify it, or replace it. That Congress believed it might need to 'reimpose the rate cap after it expires' clearly evidences its intent that the Commission had the authority, after its review, to eliminate the price cap through the potential modification or adoption of an alternative system."); USPS March 20 Comments at 26 ("Indeed, as noted above, the plain meaning of 'alternative' is expansive, and does not support such a restricted reading. Nor does the statutory context suggest that "alternative system" should be read as containing an implicit qualifier: 'alternative price cap system.'").

former system, the juxtaposition of both options indicates that Congress did not intend for the Commission to limit itself to price-cap-based models. Just because a price cap was the first system under the PAEA does not mean that it is necessarily the best way to achieve the objectives today or in the future. Rather, Congress enacted Section 3622(d)(3) precisely so that the market-dominant regulatory system could evolve to account for changing circumstances.[79]

Legislative history reinforces the breadth of the Commission's purview. As the Commission knows, Section 3622(d)(3) represents a compromise. The Senate's concept of a strictly CPI-based ratemaking system would prevail for ten years, giving way thereafter to the House's concept of broad Commission discretion. The House version of the PAEA "provided that the ratemaking system could include one or more of several types of systems: incentive regulation (*e.g.*, price caps, revenue targets); cost-of-service regulation; or any other form of regulation that the Commission considered appropriate to achieve the objectives, consistent with the factors."[80] Although the final version of the PAEA did not include this precise wording, it is clear that, consistent with the vision of the House bill, it incorporates a principle of broad Commission discretion

[79] In addition, and discussed further below, nothing in Section 3622 suggests that, simply because a price cap system was Congress's initial choice in 2006, the Commission must maintain a price cap in 2018. *See* USPS March 20 Comments at 27, 42-44. While Congress's decision to impose a price cap in 2006 arguably made sense given various considerations discussed by the Postal Service in its March 20 Comments (the fact that price cap systems oftentimes immediately succeeded cost-of-service systems, the volume trends at the time, and the relatively short length of time that the Postal Service had been substantially improving efficiency), those factors no longer justify the continuation of a price cap system.

[80] Order No. 4258 at 20 (citing 151 Cong. Rec. H6523 (daily ed. July 26, 2005)). The House bill included a general-purpose CPI limitation, but this could be waived whenever "reasonable, equitable, and necessary." *Id.*

that can encompass non-price-cap modes of regulation: revenue targets, cost-of-service regulation, and any other type of system that the Commission might find.

In fact, there are myriad examples of alternative systems adopted under standards similar to Section 3622's objectives.[81] Under similar legislated principles and in similar market environments, the Canadian, U.K., French, and German postal regulators have taken different approaches, from price caps that explicitly account for cost and volume trends (France, Germany, and the former U.K. regulator), to the replacement of failed price caps with reliance on regulatory monitoring and market discipline (Canada and the current U.K. regulator), and, still further, to a flexible non-price-cap form of *ex ante* regulation (Australia).[82] Other regulatory environments are no

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[81] Order No. 4257 does not provide a reasoned explanation of the Commission's failure to address record evidence about other regulatory models. Faced with pages of submissions on the subject, the Commission asserts that "the unique nature of the Postal Service makes it difficult to compare to other entities." Order No. 4257 at 91. That may be true of unregulated private delivery carriers, which comprise the sole examples that the Commission uses to elaborate on this point. But that assertion does not hold for foreign postal operators and domestic utilities, which face the same problems of fixed universal-service costs and declining demand as the Postal Service, and which are regulated under statutory criteria comparable to the objectives at issue here. *See* USPS March 20 Comments at 153-75 & appx. E at 12-28. For example, U.K. postal regulator Ofcom found that, "in circumstances where Royal Mail is struggling financially and Ofcom has a primary duty in relation to the continued provision of the universal service," "a[n RPI–X] price control-based approach has demonstrably failed to deliver on the required regulatory objectives," including efficiency improvement, consumer protection against undue price increases, and financial sustainability of universal service. *Id.*, appx. F at 8 (quoting Ofcom, Securing the Universal Postal Service: Decision on the New Regulatory Framework (Mar. 27, 2012) [hereinafter "Ofcom March 2012 Decision"], at 4, http://tiny.cc/Ofcom-2012-dec). Moreover, just as the challenges facing the Postal Service are not unique in the postal sector generally, neither is the Postal Service's status as a wholly owned governmental entity with a mandate to provide postal services in a business-like manner unique within the postal sector; other posts, such as Canada Post and Australia Post, have essentially the same status. Finally, as for domestic utility regulation, the Commission's avowed dismissal of alternative utility-regulation models as a matter of principle is difficult to square with the Commission's simultaneous invocation of such regulatory practice as a source for one of its proposed modifications. *See* Order No. 4258 at 55-56 & fn.74.

[82] USPS March 20 Comments at 153-75; *see generally id.*, appx. F. In addition to not explaining why a price cap is superior to alternative models for achieving the alternatives, the Commission does not explain why it is necessary to continue applying a price cap to every type of market-dominant mail. Four of the five foreign postal regulatory models that the Postal Service analyzed limit price cap regulation to single-piece letters, in recognition of the fact that business mailers have more leverage to protect their short-term pricing interests. USPS March 20 Comments at 172. The Commission itself has acknowledged that, as far as the price component of the universal service obligation is concerned, "price caps could be

less diverse: for example, a few electrical utility regulators continue to experiment with price caps, a plurality uses revenue targets to address declining demand, and the overwhelming majority still uses cost-of-service regulation, albeit with specific measures to incentivize efficiency gains.[83] Regarding other federal regulators, the FCC and FERC's price caps incorporate a number of backstops to ensure adherence to the "just and reasonable" standard, such as automatic stabilizers and the possibility of cost-of-service ratemaking, to avoid depriving regulated firms of needed revenues.[84] Another federal regulator, the Surface Transportation Board, relies on *ex post* regulation in situations of market-dominance.[85]

All of these regulators operate under "just and reasonable"-type ratemaking standards that, like various of the Section 3622 objectives, inhere a balance between short-term consumer protection (in terms of stable, predictable, and non-excessive rates, robust efficiency incentives, and high-quality service) and long-term consumer protection (in terms of the medium- and long-term financial stability of universal service).[86] While Congress may have specified the Section 3622 objectives somewhat differently, those objectives are both comparable and capacious enough to allow for consideration of any number of existing regulatory models.

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limited to single-piece products." Postal Regulatory Comm'n, Report on Universal Postal Service & the Postal Monopoly (Dec. 19, 2008), at 185.

[83] USPS March 20 Comments, appx. E at 16-17.

[84] *Id.*, appx. E at 14-15, 18.

[85] *Id.*, appx. E at 13.

[86] The Commission aptly recognizes that the current system's threat to the Postal Service's financial stability "negatively impact[s] the mailing industry as a whole." Order No. 4258 at 33-34.

B. Invocation of Objective 2 Is Not Enough to Avoid Considering Alternative Models

To be sure, the Commission has the statutory discretion to decide that a modified price cap system, rather than an alternative system, is "necessary to achieve the objectives." But the Commission did receive significant comments arguing for alternative systems, including the Postal Service's proposal for a robust regulatory system predicated on monitoring and forward guidance.[87] Given the fundamental failures that the Commission attributed to Congress's initial experiment with a price cap system, the Commission must provide a reasoned explanation of its choice to retain a price cap, especially in response to "vital comments."[88] Order No. 4258 does not do so. In fact, the Commission not only proposes to retain a price cap system generally, its proposed modifications to the existing price cap are too modest to correct the current system's rigidity and other deficiencies, as discussed in section IV below. In doing so, Order No. 4258 does not even explain its failure to incorporate other commenters' proposed modifications to the price cap system that would render the system more robust.[89]

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[87] USPS March 20 Comments at 175-228; APWU March 20 Comments at 29-31; NALC March 20 Comments at 2, 15-18; Comments of the National Postal Mail Handlers Union, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 5.

[88] *USPS v. Postal Regulatory Comm'n*, 785 F.3d 740, 744 (D.C. Cir. 2015) ("An agency action must be supported by 'reasoned decisionmaking,' whether taken in the course of rulemaking or adjudication." (citation omitted)); *Thompson v. Clark*, 741 F.2d 401, 409 (D.C. Cir. 1984) ("[A]n agency decision may not be reasoned if the agency ignores vital comments regarding relevant factors, rather than providing an adequate rebuttal.") (quoting *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 416 (1971)).

[89] *See* Public Representative March 20 Comments at 31-56, 58 (proposing true-up and adjustment factors for non-controllable expenses and the effect of volume declines on fixed costs); Comments of Mailers Hub LLC and the National Association of Advertising Distributors, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 7-8, 10-11 (adjustment for non-controllable expenses). *See also* Initial Comments of the Greeting Card Association, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 4-8 (criticizing the current system's failure to distinguish between controllable and non-controllable expenses). Order No. 4258 acknowledges these proposed modifications, Order No. 4258 at 31, but, beyond (possibly) the two non-

The closest Order No. 4258 comes is with a remark that is dubious on its face, as well as a *non sequitur*. After summarizing comments supporting and opposing a continuation of the current system,[90]

> the Commission determines that it would be inappropriate to retain the existing ratemaking system unchanged. . . . At the other extreme, however, the Commission determines that it would be inappropriate to design a system that lacks a mechanism to limit the magnitude of price adjustments. Such a mechanism is necessary to create predictability and stability, as required by Objective 2.[91]

The first quoted sentence is responsive to comments urging the retention of the current system, and sets forth a conclusion that is based on extensive analysis showing how the current system has failed to achieve the objectives. The remainder of the quotation suggests an intention to respond in kind to comments urging the elimination (or substantial modification) of the price cap. However, Order No. 4258 contains no other explanation or justification for rejecting the Postal Service's proposal, aside from this sparse reference to objective 2.

Insofar as these sentences suggest that objective 2 requires some form of price cap, that justification is insufficient. For one thing, it is at odds with the Commission's acknowledgment earlier in the same order of its statutory authority to eliminate the cap based on the plain language of the statute: that is, its broad authority to adopt an "alternative" system.[92] Interpreting objective 2 as requiring a price cap system would either render that grant of authority superfluous, or would give it an unreasonably

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responsive sentences quoted and discussed below, fails to explain why the proposed rules did not include them.

[90] Order No. 4258 at 28-33.

[91] *Id.* at 33 (citing Order No. 4257 at 103).

[92] *Id.* at 14-25.

narrow construction. Indeed, the House version of the PAEA expressly contemplated that non-price-cap regulatory models would be consistent with objective 2.[93] As noted in section III.A above, the fact that the House bill included a general-purpose CPI limitation does not mean that such a substantive limitation is itself necessary to achieve objective 2, because that limitation would have been waivable whenever “reasonable and equitable and necessary.”[94] Even the Senate bill, which would have imposed a permanent CPI-only cap, considered it necessary to specify that condition expressly, rather than assuming it as implied within objective 2.[95] If Congress had intended objective 2 to enact a requirement for price cap regulation, Congress clearly could and would have said so, instead of hiding an elephant in that particular mouse-hole.[96]

For another thing, the quoted sentences are at odds with the Commission’s own standard for objective 2, as announced in Order No. 4257. Objective 2 does not mandate a substantive “mechanism to limit the magnitude of price adjustments”; rather, it requires any rate-regulation system to “foster[ ] prices for all market dominant products that, <u>with regard to both timing and magnitude, are capable of being consistently forecast</u> and <u>do not include sudden or extreme fluctuations</u>.”[97] Consistent

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[93] H.R. 22, 109th Cong. § 201(a) (2005) (allowing that a ratemaking system “designed to achieve” a “predictability and stability in rates” objective could take the form of price caps, revenue targets, another form of incentive regulation, cost-of-service regulation, or any other form). As noted in the preceding section of these comments, under the legislative compromise that Section 3622(d)(3) embodies, the House’s vision that the Commission be given broad authority under Section 3622 is essentially what is now in effect.

[94] H.R. 22, 109th Cong. § 201(a).

[95] S. 2468, 108th Cong. § 201(a) (2004).

[96] *Whitman v. Am. Trucking Ass’ns*, 531 U.S. 457, 468 (2001) (“Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions – it does not, one might say, hide elephants in mouseholes.” (citations omitted)).

[97] Order No. 4257 at 55 (emphasis added).

with the fact that objective 2 itself does not mandate price cap regulation, the Commission's standard does not do so, either. To the contrary, it stays relatively close to the text of objective 2, by requiring, in essence, that the mailers should have stable expectations about the size and pace of future price changes.

Therefore, even if the Commission might conclude that a price cap system is the appropriate means to achieve the objectives for the time being, it cannot claim that a price cap is the only means of doing so. In fact, any number of regulatory models could be consistent with the Commission's objective 2 standard. In liberalizing postal regulation, U.K. regulator Ofcom focused on providing Royal Mail the commercial flexibility to meet customers' needs as to notice, and reduced the minimum required notice for universal-service-product price changes from three months to one month.[98] Ofcom recognized that volume pressures make Royal Mail sensitive to customers' pricing interests and their need for additional advance notice, where warranted.[99] A "safeguard cap," set high enough to give Royal Mail ample flexibility for market-based decision-making, added a backstop against unduly high price changes (as well as predictability as to the range of potential price increases).[100] After an initial true-up, market discipline, including sensitivity to the possibility of asymmetric demand responses to price increases, has actually led Royal Mail to limit price increases to

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[98] Ofcom, Securing the Universal Postal Service: Decision on the New Regulatory Framework (Mar. 27, 2012) [hereinafter "Ofcom March 2012 Decision"], at 65-70, http://tiny.cc/Ofcom-2012-dec. However, Ofcom retained ten weeks' notice for changes to downstream-access-product prices. *Id.* at 72-76.

[99] *Id. at* 61-64, 69-70. *See also* Ofcom, Review of the Regulation of Royal Mail (Mar. 1, 2017), at 3-4, http://tiny.cc/Ofcom-03-17-review.

[100] USPS March 20 Comments at 224-28 & appx. F at 10-11. A safeguard cap is unnecessary to ensure affordability for Single-Piece First-Class Mail users. *Id.* That said, the Commission does not explain why, if it believes that the Postal Service's Ofcom-modeled proposal somehow fails objective 2, that problem could not be remedied through modifications like the addition of a safeguard cap.

slightly more than the rate of consumer inflation, validating Ofcom's finding about Royal Mail's inherent price-restraint incentives.[101] Beyond Ofcom's example, revenue caps and more cost- and volume-responsive price cap formulas can likewise furnish customers with stable expectations as to price trajectories. Even in a cost-of-service system, the thoroughness of regulatory review ensures against undue fluctuations and gives mailers plenty of advance notice of potential price increases. A mere invocation of objective 2 is not enough to justify ignoring alternatives that might do a better job at achieving the statutory objectives.[102]

C. The Postal Service's Proposed Alternative Is Expressly Designed to Achieve Objective 2, as Defined by the Commission

In addition to accommodating, rather than barring, alternatives beyond the Commission's modest proposed modifications to the price cap system, objective 2 is explicitly addressed in the Postal Service's proposal for an alternative system.[103] Indeed, the Postal Service devoted an entire section of its earlier comments to the topic

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[101] Royal Mail, Response to Ofcom's July 2015 Discussion Paper: Review of the Regulation of Royal Mail (Sept. 18, 2015), at 34-37, http://tiny.cc/RM-2015-comments. Royal Mail has continued to raise its basic rates at or only slightly above the rate of inflation. *See* Edmund Greaves, *Royal Mail Announces Inflation-Busting Stamp Price Hikes*, MONEYWISE (Feb. 19, 2018), http://tiny.cc/Moneywise-RM-2018 (comparing 3.05- to 3.9-percent stamp price increases with 3.0-percent consumer inflation); Helen Knapman, *Buy First and Second Class Stamps Now as Prices Set to Rise*, MONEYWISE (Feb. 27, 2017), http://tiny.cc/Moneywise-RM-2017 (comparing 1.5- to 1.8-percent stamp price increases with 1.8-percent consumer inflation). In addition to market factors, Ofcom has also attributed Royal Mail's pricing restraint to "political pressure, negative publicity, and [Ofcom's] monitoring regime." Ofcom, Review of the Regulation of Royal Mail (Mar. 1, 2017), at 35, http://tiny.cc/Ofcom-03-17-review. All of those factors would apply equally to the Postal Service, if it were subject to monitoring-based regulation.

[102] *See PSEG Energy Res. & Trade LLC v. FERC*, 665 F.3d 203, 209 (D.C. Cir. 2011) (remanding FERC's order where, in response to an electricity generator's comments about a proposal's inconsistency with fundamental policy goals, FERC merely recited the underlying rule's purpose, without "suggest[ing] that – let alone explain[ing] how – it was a response to [the commenter's] policy arguments").

[103] At the time, the Postal Service was working from the Commission's proposed interpretation of objective 2 in Order No. 3673, but Order No. 4257 adopted that interpretation in all relevant respects. Order No. 4257 at 54-55.

of why "a price cap is not needed to provide predictability and stability of rates."[104] The Postal Service explained why a CPI-based cap has not actually gone as far toward achieving objective 2 as is often claimed: periods of low to negative inflation prevented the Postal Service from maintaining a predictable price-adjustment schedule, and the strictures of the "exigency" safety valve (as applied by the Commission) produced a surcharge that caused rates to seesaw.[105] The Postal Service also specifically addressed the "magnitude" aspect of objective 2: a moving-average-CPI-based methodology actually does not allow mailers to consistently forecast class-level pricing authority at a later point in time, much less the Postal Service's actual pricing behavior about how much cap space it will use and how that cap space will be distributed.[106] Because the Commission's proposed rules would continue to base the Postal Service's class-level pricing authority on the vagaries of CPI, it remains just as vulnerable as the current system to these objective 2 shortcomings. Order No. 4258's assertion of principle – that some "mechanism to limit the magnitude of price adjustments . . . is necessary" – does not begin to answer the question of whether the Commission's chosen mechanism allows for consistent forecasting, as the Commission has held that objective 2 requires.

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[104] USPS March 20 Comments at 201-11 (capitalization omitted).

[105] *Id.* at 205-06. A less narrow application of the exigent provision might have avoided this seesawing by producing a surcharge that could last until the ten-year review, which could have addressed its fate along with that of the rest of the current system. *See* Reply Comments of the United States Postal Service, PRC Docket No. R2013-11 (Dec. 9, 2013), at 114-18.

[106] USPS March 20 Comments at 206-09. *See also* Comments of Mailers Hub LLC and the National Association of Advertising Distributors, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 4 ("[T]he predictability and stability of the cost of living[is] not something within the control of, nor necessarily relevant to, the Postal Service. Moreover, should the CPI start to rise dramatically, or should inflation set in at the rate seen in the 1980s, postage rates might be predictable but not in the way that the PAEA's authors would have hoped, and 'stability' might be replaced with volatility.").

The Postal Service designed its proposed regulatory-monitoring approach to achieve all of the statutory objectives. For objective 2, the Postal Service proposed to couple elimination of an *ex ante* price control with (1) regulatory monitoring of the Postal Service's pricing behavior to ensure that market forces are adequately keeping it within the bounds of "stability,"[107] and (2) "a requirement that the Postal Service provide forward guidance regarding rate changes."[108] Under its proposal, the Postal Service "would . . . be able to increase rates at regular intervals," as opposed to the multi-year intervals between pre-PAEA price changes; this alone would give mailers predictability as to timing and magnitude and would avoid extreme fluctuations, consistent with the Postal Service's inherent incentive to avoid needlessly driving away volume.[109] But the Postal Service did not stop there. It went on to propose a forward-guidance regime that "would enable mailers to anticipate and budget for rate increases."[110] This proposal was modeled on the successful established practice of the Federal Reserve System Board of Governors' Federal Open Market Committee (FOMC) regarding the path of federal funds interest rates, over which the FOMC exercises its own, uncapped policy discretion, similar to the Postal Service's proposed discretion over pricing.[111]

While the Postal Service's proposal would leave the details of a forward-guidance regime to the Commission's discretion, the Postal Service illustrated the concept with a schedule whereby it might provide 12 months' notice of the next price

[107] USPS March 20 Comments at 223.

[108] *Id.* at 201.

[109] *Id.* at 202.

[110] *Id.* at 202.

[111] *Id.* at 202-04.

adjustment date, 9 months' notice of the class-level percentage changes, 6 months' notice of product-level percentage changes and structural changes, and 3 months' notice of specific price and structural changes.[112] As the Postal Service explained, such specific advance guidance of actual pricing plans, not just pricing authority, would actually go farther than any class-level CPI-based price cap – including the Commission's Order No. 4258 proposal – toward allowing mailers to consistently forecast the timing and magnitude of price increases.[113] And it should be emphasized that this concept goes far beyond the one-month minimum notice that Ofcom deemed to be necessary to protect postal customers in a similar declining-demand environment.[114]

It is important to note that the forward-guidance concept is an integral part of a larger proposal, in combination with reliance on market discipline and regulatory monitoring, rather than a standalone proposal in its own right. The underlying principle is that the market pressures of declining demand give the Postal Service ample reason to provide mailers with stable expectations, lest they give up on the mail.[115] If the Postal Service were given more control to set prices in response to demand and other business conditions, it should be better able to firm up its own pricing plans well in advance of implementing changes and to therefore enhance predictability and stability.

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[112] *Id.* at 204-05. It should be emphasized that, contrary to its portrayal in Order No. 4258 at 100, this was not a concrete proposal, but an illustration of the type of forward guidance framework that the Commission could adopt.

[113] USPS March 20 Comments at 205-11.

[114] Ofcom March 2012 Decision at 69-70. Ofcom noted that business mailers do not typically receive more than one month's notice, if any, of changes to other inputs in their own cost structures. *Id.* at 69.

[115] *See* Comments of the Major Mailers Association, the National Association of Presort Mailers, and the National Postal Policy Council, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 22 (crediting the Postal Service with "working proactively with mailers to help them anticipate the timing of upcoming rate adjustments beyond simply maintaining the schedule").

By contrast, *ex ante* regulation renders the Postal Service less able to plot its future course. Under the rules proposed by the Commission, rate authority would still be dependent on CPI, meaning the problems with predicting the course of CPI would remain. Additionally, other amounts of class-level pricing authority would be determined in the Annual Compliance Determination (ACD), as well as a new post-ACD appeal process. No price cap system, including the one proposed in Order No. 4258, would provide the level of predictability that the mailers seek.[116] It may be that no *ex ante* regulatory system could do so adequately, while preserving the Postal Service's pricing flexibility and meeting the other objectives. But the Postal Service could, if only it had the flexibility to develop prices based on market conditions, rather than on the technical demands of *ex ante* regulation.

D. Order No. 4258 Does Not Account for How the Postal Service's Alternative Would Better Achieve the Other Objectives

Unlike the current system (or the Commission's proposed system), the Postal Service's proposed alternative system would achieve every statutory objective.[117] The Postal Service would have the flexibility to set its prices at a reasonable level to ensure financial stability; fund investments in efficiency, service, and security; and guard against inefficient pricing (objectives 1, 3, 4, 5, 7, and 8). That greater control would enhance the Postal Service's ability to provide more specific advance notice of the magnitude and timing of price changes (objective 2). As other postal regulators have done, the Commission would recognize that the current market environment already

[116] *See id.* at 23; Comments of Connectiv, a Division of the Software & Information Industry Association, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 6-7.

[117] USPS March 20 Comments at 175-211, 218-24.

supplies maximum incentives for the Postal Service to reduce costs, increase efficiency, maintain high-quality service standards, and restrain price increases (beyond what is necessary for medium- and long-term financial stability), rendering *ex ante* regulation both unnecessary and ineffective (objectives 1, 3, and 8).[118] Instead of maintaining *ex ante* price control on the assumption that extra-market constraints are needed, the Commission would conduct robust monitoring of rates, costs, financial condition, cost reduction initiatives, efficiency improvements, and service performance, in order to assess whether and when to intervene (all objectives). Without *ex ante* price regulation, administrative burden would be reduced, while forward guidance and monitoring would increase transparency (objective 6). Meanwhile, the threat of intervention itself would serve as a regulatory check against theoretical abuses by the Postal Service.[119]

The Postal Service's proposal would achieve all of these objectives in a simple, direct manner. By contrast, Order No. 4258's proposed rules would try to patch a failed price cap model with incremental half-measures that are ultimately just as rigid as the original system. In addition, as sections IV and V will explain, the Commission's proposed fixes do not go nearly far enough to make good on the Commission's stated (and mandatory) purpose of achieving the statutory objectives. For instance, a reasonable cap-based remedy for the current system's failings would require the use of

[118] U.K. postal regulator Ofcom has consistently found that market discipline is adequate to protect consumers even though Royal Mail's shareholders would, in theory, benefit from rent-seeking. *See* USPS March 20 Comments at 187-88. If anything, that should indicate even less need to regulate the Postal Service, which faces the same market environment without shareholders who might demand short-term profits through excessive price increases. Rather than maximizing profits, the Postal Service's mission is to maintain the long-term viability of universal service. *Id.* at 186, 189. This mission, as well as extensive internal and external scrutiny, also translates into inherent incentives to improve efficiency notwithstanding the lack of shareholders. *Id.* at 200-01.

[119] *Id.* at 178, 222 fn.436.

a reasonable and representative net-loss baseline, factors to adjust that baseline for the effect of exogenous density and cost changes,[120] and achievable targets for any performance-based rate authority.

However, the elements necessary to ensure a robust price cap system capable of achieving all of the objectives requires that the system be less simple, transparent, and predictable than the alternative system proposed by the Postal Service. The continued reliance on CPI to set class-level cap space would also pose the same predictability/stability drawbacks as the current system, as discussed in section III.C. And the Commission would run the significant risk of regulatory error: even if it sets price cap components at levels that seem reasonable in 2018, they could still prove inadequate to meet the statutory objectives as real-world circumstances unfold.[121] The risk is all the greater to the extent that the Commission decides not to incorporate the well-established mechanisms for a more flexible and effective price cap system that the Postal Service proposes in these comments, and instead maintains the rigid structure it has proposed.

The postal community has seen this movie before. Even with periodic true-ups, the former U.K. postal regulator Postcomm found itself adding ever more layers of complexity in its effort to sustain cap-based regulation amid declining letter-mail

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[120] *See id. at* 211-12.

[121] *Id. at* 212 ("[T]he postal marketplace is both inherently uncertain and extremely challenging for the Postal Service[.] For instance, future volumes of market-dominant products are subject to a large number of non-price factors that are ultimately outside of the Postal Service's control, including future economic conditions and future trends in electronic diversion. Given these factors, as well as the Postal Service's current precarious financial position, the Postal Service's ability to maintain financial stability, and hence achieve the various other objectives that are dependent on financial stability, would be extremely sensitive to the assumptions used by the Commission in designing an alternative cap.").

demand. Even with adjustment factors for changes in volume and in Royal Mail's pension liabilities, Postcomm had to reopen the cap and provide extraordinary relief. After a decade of disappointment across the postal community, Parliament discharged Postcomm and shifted regulatory duties to Ofcom.[122] Ofcom promptly ruled the experiment with ever-more-baroque price cap regulation to have disserved the interests of financial stability, consumer protection, and efficiency, all while saddling the regulator with responsibility if the price cap did not keep pace with initial expectations.[123] Ofcom recently reaffirmed its commitment to the monitoring approach, finding that reimposition of a price cap would not offer commensurate benefits, especially in light of the concomitant regulatory risk.[124]

The Commission does not need to repeat Postcomm's failed experiment in order to learn from its mistake. For more than five years, the Ofcom model has shown that a monitoring approach can do a better job of providing financial stability, ensuring efficiency improvement, and protecting consumers' interests.[125] There is no reason to think that the Postal Service, any more than Royal Mail, would be insensitive to market forces that would punish it for raising prices above the level and pace necessary for

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[122] *Id.*, appx. F at 7-8.

[123] USPS March 20 Comments at 198-99, 212-14 & appx. F at 8-10. Ofcom has also found that Royal Mail's service performance improved substantially since the shift from price cap regulation to a monitoring approach. Ofcom, Review of the Regulation of Royal Mail (Mar. 1, 2017), at 18-19, http://tiny.cc/Ofcom-03-17-review.

[124] USPS March 20 Comments at 199-200, 214-16 & appx. F at 12-13. Canada also abandoned the *ex ante* price cap model, due to its failure to "reflect the significant labour component of [Canada Post's] costs[,] fuel and transportation related costs[,] and capital renewal needs or requirements of the business." *Id.*, appx. F at 15-17 (quoting Strategic Review of the Canada Post Corporation: Report of the Advisory Panel to the Minister, part II(III)(v) (2008) (Can.), *archived at* http://tiny.cc/CPC-Strategic-Review). *See also id.* at 217. Meanwhile, the need to reopen the French and German price caps shows the risk inherent in their complex structure. *Id.* at 217-18 & appx. F at 27-30, 34-37.

[125] *Id.*, appx. F at 13-14.

financial stability, for slackening its efficiency initiatives, or for degrading service below market needs.[126] And, as Ofcom observed, there is no reason to think that a regulator is better-positioned than an operator to make decisions about the operator's commercial interest and to respond to customers' needs.[127]

The Commission should heed the U.K. lesson, abandon its attempt to "fix" the price cap by adding complexity, and embrace the benefits of a streamlined monitoring approach. The sections that follow bear out this point, by illustrating the numerous aspects of Order No. 4258's proposal that would need to be fixed in order to achieve the statutory objectives in a meaningful, coherent manner. In any event, the Commission cannot simply dismiss the Postal Service's proposal without offering a reasoned explanation for its choice not to use its broad authority to adopt a proven alternative model that, as the Postal Service has comprehensively explained, stands a far better chance of meeting the statutory objectives.

IV. THE COMMISSION'S PROPOSED SUPPLEMENTAL RATE AUTHORITY WILL NOT PLACE THE POSTAL SERVICE ON THE PATH TOWARD "MEDIUM-TERM FINANCIAL STABILITY"

Even if the Commission decides to adhere to a system that includes a price cap, it must design the system in a way that actually achieves the statutory objectives. For the reasons explained below, it has not done so.

The purpose of price cap regulation is to protect consumers from unreasonably high prices by setting a ceiling on a regulated entity's pricing authority and thereby

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[126] *See id.*, appx. F at 9-10 (citing Ofcom March 2012 Decision at 4, 6, 53, 57-64, 91, 93, 100 fn.104). It bears repeating that experience has borne out Ofcom's hypothesis: after a substantial initial price increase, demand pressures have compelled Royal Mail voluntarily to keep its price increases within the rate of consumer inflation. *Id.*, appx. F at 11-12.

[127] *Id.*, appx. F at 9 (citing Ofcom March 2012 Decision at 61-64).

encouraging that firm to operate more efficiently, instead of simply passing its costs on to consumers in the form of higher prices.[128] At the same time, for a price cap system to work properly, it must provide a regulated firm with a meaningful opportunity not only to cover its total costs (the Commission's interpretation of "medium-term stability"), but to earn profits otherwise unavailable under cost-of-service regulation, based on the ability of the firm to continue to operate its business efficiently.[129] Those profits may be used for purposes such as funding capital investments that further reduce costs and improve service (the Commission's interpretation of "long-term stability").

To achieve those purposes, price cap systems have two basic elements: a baseline, or "going in" rate level (often derived from a previous cost-of-service regime), and a "going forward" formula to regulate future rate increases. The baseline rate must be compensatory but not excessive – for instance, if it is set too low, the system will produce persistent net losses.[130] The formula typically consists of both a measure of

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[128] *See, e.g., Time Warner Entm't Co., L.P. v. F.C.C.*, 56 F.3d 151, 171 (D.C. Cir. 1995); In the Matter of Implementation of Section of the Cable Television Consumer Prot. & Competition Act of 1992 Rate Regulation, 8 F.C.C. Rcd. 5631, 5776-77 (1993) (footnotes omitted).

[129] *See, e.g.*, *Ass'n of Oil Pipe Lines v. FERC*, 281 F.3d 239, 244 (D.C. Cir. 2002) ("The prospect of imminent bankruptcy surely concentrates the mind. But if this is the justification, it amounts to no more than the principle that 'lower is better'-an argument that seems to have no end and little connection to any stated purpose."); *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 177–78 (D.C. Cir. 1993) (describing theory behind price cap regulation). *Accord* In the Matter of Policy & Rules Concerning Rates for Dominant Carriers, 4 F.C.C. Rcd. 2873, 2899-2933 (1989) (discussing the merits of a price-cap system and the problems associated with a rate-of-return system).

[130] *See* USPS March 20 Comments, appx. E at 29 & fn.72 (arguing that "rate resetting would appear to be necessary so that market-dominant rates would be just and reasonable at the outset of a new regulatory system," and noting that the "accepted regulatory meaning of 'just and reasonable' [rates] inheres the notion that rates must be compensatory but not excessive"). *Accord* In the Matter of Policy and Rules Concerning Rates For Dominant Carriers, 5 F.C.C. Rcd. 6786, 6814-15 (Oct. 4, 1990) (concluding that existing cost-of-service rates "are the most reasonable basis from which to launch a system of price cap regulation" because they "are in general the best that rate of return regulation can produce"); *see also, e.g.,* Declaration of Timothy J. Brennan, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 5 ("To ensure that the regulated firm is able to cover costs at the start, the initial price may be based on [cost-of-service regulation]."); Peter Navarro, *The Simple Analytics of Performance-Based Ratemaking: A Guide for the*

inflation and adjustments to that inflation measure to account for expected industry unit-cost changes.[131] If the formula is developed properly, then it allows a firm to earn a profit (assuming that the original benchmark rates are compensatory) to the extent that the firm operates more efficiently than the expected efficiency of the regulated industry as a whole. Put another way, the formula establishes in effect a reasonable going-forward efficiency target (including cost levels) that a regulated entity would be expected to meet, given the characteristics and circumstances of the industry, over the period in question. If the going-in rate is set at an appropriate level, the efficiency target would give the firm the authority to generate enough revenue through pricing to earn profits and accumulate retained earnings, to the extent that it meets or exceeds that efficiency target. Accordingly, under a well-designed system, the extent to which the firm is profitable should depend entirely on the firm's performance: that is, it depends on the efficiency gains the entity can achieve and the ability to contain the costs over which it has control, rather than on industry-wide (or economy-wide) cost trends over which the individual firm has no control.[132]

PBR Regulator, 13 YALE J. ON REG. 105, 128 (1996) (noting that "setting the baseline correctly is absolutely critical to the success" of price cap regulation).

[131] *See* USPS March 20 Comments, appx. E at 14.

[132] Although price caps are generally designed to disconnect a firm's pricing authority from a firm's individual costs, under the theory that such disconnect will avoid dissuading firms from cost-cutting efforts, *see Ass'n of Oil Pipe Lines v. FERC*, 281 F.3d 239, 244 (D.C. Cir. 2002), this does not mean that price caps should be arbitrarily set at a level disconnected from prices that are beyond a firm's (or an industry's) control. *See id.* (rejecting argument that an arbitrarily low price-cap index still serves the purpose of encouraging cost-cutting on the "partially facetious[ ]" ground that one could achieve that "purpose by 'relat[ing] the change in permissible prices over time to a random table of numbers'") (quoting Test. of Alfred E. Kahn, *Revision to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, F.E.R.C. Docket No. RM93-11-000, at 4 (Aug. 12, 1993) ("1993 Kahn Study")); *see also* In the Matter of Policy and Rules Concerning Rates For Dominant Carriers, 5 F.C.C. Rcd. 6786 (Oct. 4, 1990) (discussing the balancing that occurs in the design of a price cap regime to achieve statutory polices, including the need to ensure that a "price cap formula [does not] stray so far from actual costs that the cap will produce unreasonably low rates"); In the Matter of Policy & Rules Concerning Rates for Dominant Carriers, 4

Although those goals are relatively easy to articulate, designing a properly functioning formula to achieve those goals is difficult. The report by Christensen Associates, filed with the Postal Service's March 20 comments, addresses that difficulty by noting that a well-designed price cap system usually considers "multiple factors to reflect industry or firm-specific circumstances (e.g., unanticipated changes in volumes), automatic stabilizers, off-ramps, and periodic true-ups and fine-tuning,"[133] so that the system balances consumers' short-term interest in lower rates against consumers' longer-term interest in ensuring the continued viability and stability of the industry.[134] As Christensen discusses, such considerations underlie the price cap systems implemented by other federal regulators.[135]

The PAEA illustrates the problems caused when a price cap system lacks those design elements. The PAEA plainly had the above-mentioned goals in mind – as noted above, Congress intended the system to ensure "adequate revenues, including retained earnings," as well as "just and reasonable" rates, while incentivizing cost reductions and improved efficiency. However, as the Commission found throughout Order No. 4257 and Order No. 4258, the PAEA's price cap failed to achieve those objectives, and specifically did not ensure the Commission's view of "medium-term stability," meaning

F.C.C. Rcd. 2873, 2878 (1989) (noting that a "workable" price cap formula is one that is "designed to ensure a continuing nexus between tariffed rates and the underlying costs of providing service"); 1993 Kahn Study at 2-4 (explaining that a price-index formula should begin with "just and reasonable rates" and thereafter should adjust for "changes in cost . . . that might reasonably be expected to be achieved by an efficient operator," or else it will ultimately fail).

[133] USPS March 20 Comments, appx. E at 34; *see also* USPS March 20 Comments at 211-12.

[134] As illustrated in section III.D above, the complexity and regulatory risk involved in sustaining cap-based postal regulation amid declining mail volume has led other postal regulators to either abandon cap-based regulation or reopen it with the express goal of providing needed revenues.

[135] USPS March 20 Comments, appx. E at 14-18, 26-27.

that the Postal Service's total revenues did not cover its total costs (and indeed did not even come close to doing so).

The fundamental reason for that failure was the rigidity of the formula: it relied strictly on consumer inflation and was accordingly not flexible enough to account for the unique environment in which the Postal Service operates. Similarly, it lacked a mechanism allowing the Postal Service to adjust to fundamental changes in its operating environment, other than an "exigency" safety valve that the Commission interpreted to allow for only a very narrow recovery of losses in specified circumstances. In particular, the system did not enable the Postal Service to respond to the unprecedented decline in mail volume, which, in combination with expansion of the delivery network, produced dramatic declines in economies of density and sharply increased unit costs. As a result, the Postal Service has suffered massive net losses in every year since the PAEA's enactment.

Despite recognizing the deficiencies of the failed price cap model, the Commission's proposal does not correct them. Instead, the Commission proposes authorizing additional pricing authority that will allow the Postal Service to increase the "going-in" rate baseline and thereby offset some of the past annual net losses that the PAEA's rigid cap caused, but retaining essentially unchanged the rigid CPI-based formula going forward. As summarized here and as discussed in more detail in sections IV.A and IV.B, the proposal falls short in dealing with both aspects of a properly-designed price cap system: a reasonable "going in" baseline rate level, and a reasonable going-forward formula to regulate future rate increases.

As for the going-in baseline rates, the Commission's proposed solution – giving the Postal Service 2 percentage points of supplemental rate authority for five years, to partly offset the fact that the current system's rigidity has resulted in non-compensatory rates – is woefully insufficient. It does not reset rates to anything approaching a compensatory level, which alone ensures that the system cannot and will not allow the Postal Service to achieve (or make meaningful progress towards) "medium-term stability" over the next five years.

As for the going-forward formula, the Commission does not propose (or even consider) any adjustments to make the system more flexible to account for the types of factors that caused rates in prior years to become non-compensatory in the first place (and that will almost certainly persist into the future). Rather than redesigning the price cap around the Postal Service's financial situation and operating environment, the Commission proposes to retain the current system's rigidity and thereby to perpetuate the original price cap system's central flaw.

The Commission nonchalantly suggests that the Postal Service will just have to plug all of the proposed system's design flaws with additional cost-cutting.[136] But the Commission does not even ask, let alone answer, the pertinent questions: how much cost-cutting potential is the Postal Service reasonably likely to have over the next several years, given the legal and practical constraints in which it operates, and how

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[136] *See* Order No. 4258 at 41 (the baseline adjustment authorized by the supplemental rate authority will achieve medium-term stability "when combined with cost reductions and operational efficiency gains"); *id.* at 42-43 (noting that the Commission's analysis does not take into account "recent volume trends," specifically, that "Market dominant product volumes have been declining overall and shifting toward lower-priced products and rates," but expects "the Postal Service to achieve cost reductions and operational efficiency gains sufficient to close the gap"). *See also id.* at 54-55 (noting that performance-based rate authority, designed to generate retained earnings, will produce less revenue than the Commission's analysis suggests because of future changes to mail volume and mail mix, but that "the Postal Service will need to improve operational efficiency" to make up the difference).

much revenue does it need to cover the net-income gap left over after accounting for that cost-cutting potential? The Commission recognizes the significant statutory constraints under which the Postal Service operates (including the universal service obligation, the collective bargaining process, and the pension and retiree health benefit funding obligations),[137] but does not analyze the scope of cost-cutting opportunities available to the Postal Service in light of those constraints. Similarly, the Commission acknowledges that "[m]arket dominant product volumes have been declining overall and shifting toward lower-priced products and rates,"[138] but does not grapple with the implications of that ongoing trend in terms of the revenue the Postal Service would need or the costs it would have to remove in order to offset a large and growing revenue shortfall. Accordingly, the Commission cannot and does not find (let alone attempt to support a finding) that the proposed system will actually allow the Postal Service an opportunity to cover its total costs and thereby achieve "medium-term financial stability."[139]

A serious examination of those questions leads inexorably to the conclusion that the proposed system would not provide the Postal Service with the authority needed to actually achieve, or even make meaningful progress towards, "medium-term stability" consistent with available efficiency opportunities within the Postal Service's control. The charts in Appendix A to these comments illustrate the likely impact of the proposed system's shortcomings. The charts posit two alternative scenarios of volumes and

[137] Order No. 4257 at 198-200.

[138] Order No. 4258 at 42; *accord id.* at 54.

[139] *Id.* at 39; Order No. 4257 at 165.

revenues, a “baseline” scenario and an “optimistic” scenario, which are based on the same set of consensus economic indicators and which incorporate the same reasonable assumptions about future costs and efficiency gains,[140] but which differ in that the former accounts for the prospect of a recession during the next five years.[141] Under either scenario, the Commission’s proposal will starve the Postal Service of cash on hand and will leave the Postal Service with larger net losses in each of the next five years than it projects to have this year. In this sense, far from being “on the path” to financial stability, the Postal Service will be even further from that destination than it is now, so the proposed system is just as rigged for failure as the current system.

To be sure, the Postal Service would need to exercise its business judgment regarding the actual use of its available pricing authority, based on its assessment of conditions in the marketplace, which could impact the actual financial results that occur moving forward. However, the Commission’s task here is to give the Postal Service the requisite pricing authority, based on the level of authority needed to achieve the objectives. The Postal Service accordingly proposes adjustments that address some of the proposal’s shortcomings.

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[140] Specifically, both scenarios are based on an econometric forecast of volumes and revenues, and external economic indicators (i.e., employment and investment levels, growth in e-commerce and exports, and exchange rates). The baseline econometric forecast reflects a rate of volume loss consistent with the occurrence of a recession beginning in 2019, with the resulting effects reflected over subsequent years. Both scenarios incorporate reasonable assumptions about employment costs, cost reductions, efficiency gains, and post-retirements benefits funding. The cost savings assumptions are aggressive. For example, these forecasts assume that the Postal Service will, through continued aggressive management, achieve a high proportion of the cost-savings opportunities within management control. *See* section IV.A *infra* (discussing the expert report by Alvarez and Marsal, which was filed USPS March 20 Comments, appx. C). It should be noted that these assumptions do not necessarily represent an actual forecast or strategy; rather, they are intended to illustrate that, even with aggressive actions in other areas, the Commission’s proposal will not achieve the purposes that it is designed to achieve.

[141] *See* USPS March 20 Comments at 141 fn.270 (discussing the reasonableness of interpolating a recession in the Postal Service’s forecasts).

A. The Commission Should Adjust the Amount of Supplemental Rate Authority So That It Produces a Compensatory Baseline Rate Level

In one obvious sense, the Commission's proposed system is even worse than the current system that the Commission is trying to improve. Although the system established by the PAEA failed to meet the objectives of the PAEA, at least the baseline rate level – *i.e.*, the going-in rate at the start of the price cap regime – was reasonably compensatory overall at the time of enactment (based as it was on the previous cost-of-service model with a break-even mandate).[142] That is no longer the case, of course, as eleven consecutive years of multi-billion dollar net losses demonstrate.[143]

The Commission recognizes the problem, and purports to solve it by authorizing 2 percentage points of supplemental rate authority over five years (claimed to be the theoretical equivalent of a one-time, 5.7-percent rate increase). In an ideal world with constant volume (including no elasticity effects), this would permit the Postal Service to essentially reset its benchmark rates to recoup an additional $2.7 billion of annual revenues. The Commission's evident theory is that authorizing the Postal Service to raise prices by an additional 2 percentage points annually over the next five years will allow the Postal Service the opportunity, in conjunction with cost savings opportunities that are purportedly achievable, "to achieve medium-term stability (*i.e.*, to have total revenue equal to all attributable and institutional costs),"[144] and will accordingly "put the

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[142] Order No. 4257 at 36 ("The Postal Service had generated net income for 4 years in a row and had paid off most of its debt and accumulated retained earnings.").

[143] *Id.* at 171 (showing the shift from $3.242 billion in retained earnings in FY2006 to a $59.113 billion deficit in FY2016); U.S. Postal Serv., FY2017 Form 10-K at 46 (reporting a deficit of $61.856 billion in FY2017).

[144] Order No. 4258 at 40-41; *accord id.* at 42 (supplemental rate authority would "allow the Postal Service the opportunity to achieve medium-term financial stability").

Postal Service on the path to generating positive net income."[145] The soundness of this theory depends in large part on the truth of its premises: that 2 additional percentage points of rate authority would actually produce (over a five-year period) an average of $2.7 billion in additional annual revenue, and that $2.7 billion in additional annual revenue is sufficient to establish a reasonable "baseline" rate level for offsetting the Postal Service's net-income gap.[146]

Nowhere in Order No. 4258 does the Commission attempt to defend the choice of $2.7 billion as being a reasonable increase to the rate baseline or a reasonable estimate of the net losses that the Postal Service faces. Indeed, the Commission does not really explain why it chose that figure, other than that it happens to equal the Postal Service's net loss in FY2017. But the net-loss figure in FY2017 is plainly an outlier: it is significantly lower than the level of annual net loss that the Postal Service suffered during any sustained period since the passage of the PAEA. As the Commission recognizes, the Postal Service suffered net losses averaging roughly $6.2 billion per year – ranging from $2.8 billion (in FY2008) to $15.9 billion (in FY2012) – during the 10-year period after the enactment of the current ratemaking system.[147] Those ten years of losses are the very reason for the Commission's finding that a "medium-term financial stability" remedy is needed, yet the Commission instead relies solely on an unrepresentative net loss suffered in one year to determine the amount of annual revenue the Postal Service would need in order to rectify the lack of such stability.

[145] *Id.* at 40.

[146] The soundness of the Commission's theory also requires that the forces that caused eleven years of large net losses in the PAEA era, despite a reasonable "going in" rate level, will suddenly stop forcing net losses to recur once rates are properly reset. That flawed premise is discussed in section IV.B below.

[147] Order No. 4257 at 168 (Table II-10); Order No. 4258 at 40.

In fact, for the purposes of this proceeding, the $2.7 billion figure itself is misleading even as a snapshot of the Postal Service's financial performance in FY2017, let alone a meaningful proxy for the Postal Service's financial outlook going forward. The Postal Service's FY2017 net loss includes a significant non-cash adjustment of $2.2 billion to its workers' compensation liability under the Federal Employees Compensation Act, arising from an increase in the discount rate and changes in actuarial assumptions.[148] This non-cash adjustment is a normal change in accounting estimates, which are required in financial reports presented in accordance with accounting principles generally accepted in the United States (GAAP). It does not represent income earned in the normal course of business in that year, and, by the same token, it does not impact the Postal Service's cash position. In a year where this non-cash adjustment has a negative effect, it does not reflect actual charges or expenses paid in that year. Whether or not such accounting adjustments might smooth out over long periods of time, they can fluctuate materially from year to year and therefore can sharply distort the picture of the Postal Service's overall financial position in any given year.[149] FY2017 was a particularly dramatic example of a year in which non-cash accounting adjustments significantly affect reported net income and can mislead an unsophisticated reader if considered in isolation. But for that adjustment,

[148] *See* U.S. Postal Serv., FY2017 Form 10-K at 17; U.S. Postal Serv., FY2017 Annual Report to Congress (2017), at 20 (noting that the Postal Service's "lower-than-anticipated net loss was primarily due to a $2.2 billion reduction in workers' compensation liability (mostly caused by an increase in interest rates)"); *id.* at 24 ("In FY2017, we recorded a reduction in the workers' compensation liability of $2.2 billion, which is largely the result of prevailing interest rates being higher than the prior year.").

[149] *See* PRC FY2014 Financial Analysis Report (Apr. 1, 2015), at 16 (noting that workers' compensation liability estimates depend on interest rates that "have fluctuated significantly over the past 4 years").

the Postal Service's net loss in FY2017 would have been $5.0 billion,[150] which is far more consistent with the scale of net losses that the Postal Service suffered in the years immediately preceding FY2017.

It is true that the Postal Service accounts for such non-cash accounting adjustments in its financial reports in compliance with GAAP. But that fact does not support a myopic reliance on GAAP-compliant net-loss figures in establishing a reasonable rate-setting baseline for the next five years.[151] The Commission's obligation is (or should be) to attempt to determine the amount of future revenue that would give the Postal Service a meaningful opportunity to cover its total costs over that period. In fulfilling that purpose, the Commission should ignore the impact of non-cash accounting adjustments like the one made in FY2017, just as it should ignore analogous non-cash adjustments to the Postal Service's accruals in any given year. It cannot be foreseen what, if any, non-cash accounting changes will arise during the next five years, let alone their magnitude or direction,[152] and so it is not reasonable to incorporate into a baseline expectation of annual losses a $2.2 billion non-cash accounting adjustment that may never be repeated.[153] The Commission's proposed baseline should be derived from a

[150] The Postal Service's nominal net loss was $2.742 billion. The value of the non-cash workers compensation adjustments was $2.212 billion. The combined total was $4.954 billion, which rounds to $5.0 billion.

[151] The Postal Service's March 20 comments noted that the Postal Service properly follows GAAP in valuing its assets (such as its real property) and liabilities (such as RHB obligations). *See* USPS March 20 Comments at 150-52. Here, however, the Commission's task is not to assess the Postal Service's overall financial position, but instead to establish a reasonable net-revenue baseline that would provide the Postal Service with a meaningful opportunity to cover its total annual costs in the future.

[152] In fact, the Postal Service's accounting estimates do not even plan for these non-cash changes. *See* U.S. Postal Serv., FY2017 Annual Report to Congress at 24; U.S. Postal Serv., FY2018 Integrated Financial Plan (2017) at 3.

[153] In light of the Commission-acknowledged fluctuation of non-cash accounting adjustments, the incorporation of such an adjustment into the proposed baseline stands in stark contrast to the

clear picture of the Postal Service's underlying financial performance, not a picture clouded by the influence of non-cash accounting adjustments.

When the non-cash workers' compensation adjustment is removed, the Postal Service's FY2017 $2.7 billion net loss ceases to be an obvious outlier, as the adjusted $5.0 billion loss falls much more closely in line with the net losses suffered in the years immediately preceding FY2017.[154] It is also consistent with the $5.2 billion net loss that, even with aggressive cost-savings initiatives, the Postal Service projects for FY2018 in the Integrated Financial Plan (IFP) that it filed with the Commission in November 2017.[155] The $5.0 billion adjusted loss is therefore the absolute minimum estimate of the amount by which the Postal Service's revenue baseline should be increased. Using the Commission's calculation method (and without adjusting for volume erosion), this adjusted baseline would translate into annual supplemental rate authority of 3.3 percentage points, not the 2 percentage points proposed in Order No. 4258.[156]

To be sure, no one-year snapshot, even after filtering out non-cash accounting adjustments, will perfectly capture the Postal Service's expected financial performance for purposes of setting a compensatory baseline rate level. Accordingly, the Commission should consider using a multi-year average to get a more robust estimate

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Commission's refusal to incorporate assumptions about known, unidirectional trends like volume declines and delivery point growth.

[154] As the Commission knows, the Postal Service's total net losses ranged from $5.0 billion to $5.6 billion in each year between FY2013 and FY2016, even with non-cash accounting adjustments.

[155] *See* U.S. Postal Serv., FY2018 Integrated Financial Plan at 3; *id.* at 4 (projecting that "2018 work hours will be reduced by 23 million compared to 2017 . . . in spite of the continued growth in delivery points and the growth in more labor-intensive package volumes"); *see also* U.S. Postal Serv., FY2017 Annual Report to Congress at 21.

[156] *See* Appendix B.

of the necessary "baseline" rate level increase. The Commission could look at the most recent five-year period (FY2013-FY2017), which encompasses the period since the Commission found that, following Great Recession-era cost-reduction efforts, attributable costs began to decline faster than volume.[157] This can be interpreted as a sort of post-recession "new normal" for financial purposes.[158]

Although using a five-year average solves the problem of volatile non-cash adjustments for workers' compensation liability – such non-cash adjustments were made in each of the five years, but happen to almost entirely wash out over the period as a whole[159] – it still presents a financial picture clouded by revenue totals that do not accurately reflect the Postal Service's current rate base. Of particular significance, the five-year average includes roughly $4.6 billion in revenues that the Postal Service obtained through the exigent surcharge. The Commission authorized that surcharge to recover for the effects of the Great Recession on mail volume, and thus the surcharge

[157] Postal Regulatory Comm'n, Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2013 (Apr. 10, 2014), at 3.

[158] That is, "new normal" in a broader sense than the specific application of the phrase in Docket No. R2013-11. While the dating of a post-Great-Recession "new normal" was a subject of debate in the specific context of a Commission-established four-factor test for purposes of Section 3622(d)(1)(E), *see* Order No. 2623, Order Resolving Issues on Remand, PRC Docket No. R2013-11R (July 29, 2015), at 16-28, that test does not control here. More to the point, there is no reasonable dispute that, as a factual matter, the Postal Service's adjustment efforts were showing meaningful results by FY2013.

[159] For that reason, the use of a multi-year average rather than a single-year snapshot is particularly critical if the Commission decides not to consider common-sense adjustments to net-income figures and instead chooses to woodenly use GAAP-compliant figures in establishing a reasonable rate baseline for future years. Although accounting changes do not necessarily cancel over any given five-year period, the use of a longer time horizon will at least filter out some of the accounting adjustments that can significantly impact any given single-year sample. Even using GAAP-compliant net-income figures, however, a fully *unadjusted* five-year period does not tell a fundamentally different story than the one described above, and confirms the unreasonableness of a $2.7 billion baseline. Over the five-year "new normal" period, even including all non-cash adjustments (and thus using the artificially low $2.7 billion figure for FY2017), the Postal Service's average net loss was $4.8 billion. That figure translates into 3.2 percentage points of supplemental rate authority, still far above the 2 percentage points that Order No. 4258 would allow.

effectively represented deferred revenue the Postal Service would have earned prior to FY2013. For that reason, and also because the exigent surcharge has since expired and is no longer in the rate base, the Commission should remove the revenue gained while the surcharge was in effect for purposes of resetting the baseline for the new five-year period. Adjusting for that exigent surcharge (but not the workers' compensation adjustments over the five-year period), the Postal Service's average loss from FY2013 through FY2017 was $5.7 billion, a more realistic assessment of the Postal Service's ongoing financial performance in the post-"new normal" era, and therefore a more appropriate benchmark for recalibrating market-dominant rates. Translating that $5.7 billion figure into supplemental rate authority under the Commission's formula (and without adjusting for volume erosion), the Postal Service would require 3.8 percentage points rather than 2 percentage points of additional annual authority.[160]

The five-year historical financial picture is clouded further by two significant non-cash accounting adjustments addressing postage in the hands of the public (PIHOP).[161] Specifically, in both FY2013 and FY2016, the Postal Service revised its estimates concerning purchased but unused postage (and thus the period in which it would recognize deferred revenue), with the result being that its financial statements reflected two separate revenue increases (of $1.3 billion and $1.1 billion, respectively). However,

[160] *See* Appendix B.

[161] The Postal Service recognizes revenue for postage at the time mail is delivered, and not at the time the postage is sold. PIHOP is an estimate of the amount of postage (mostly Forever Stamps) that customers purchased but have not yet used, and that estimate is included in the Postal Service's balance sheet as deferred revenue-prepaid postage. On occasion, the Postal Service revises those estimates and makes a corresponding accounting adjustment. For example, in FY2016, the Postal Service revised its estimation technique in response to new information regarding customers' retention and usage habits, resulting in a $1.1 billion decrease in the amount of deferred revenue, which the Postal Service reflected on its income statement as a $1.1 billion increase in revenue (and thus a $1.1 billion decrease in total net loss) in FY2016. *See* U.S. Postal Serv., FY2016 Annual Report to Congress (Dec. 29, 2016), at 23.

the PIHOP adjustments do not represent revenue actually received from the rates in effect during the period in which the adjustment is made. Like the revenue received from the exigent surcharge, the revenue recognized by the PIHOP adjustments should properly be excluded for purposes of establishing a reasonable baseline for the new five-year period to the extent that it represents revenue earned before FY2013. For present purposes, one could reasonably assume that the $1.1 billion adjustment in FY2016 represents revenue that was received mostly at points earlier than FY2016 but still sometime during the five-year period in question, but that the $1.3 billion adjustment in FY2013 (like the exigent surcharge discussed above) represents revenue that was received mostly before the five-year period began.

After removing the FY2013 PIHOP adjustment to exclude revenues earned from postage sold before FY2013, in addition to removing the exigent surcharge, the Postal Service's adjusted average loss over the five-year period was $6.0 billion. Translating that $6.0 billion figure into supplemental rate authority under the Commission's formula (and without adjusting for volume erosion), the Postal Service would have 4.0 percentage points rather than 2 percentage points of additional authority.[162] While $6.0 billion exceeds the adjusted loss that the Postal Service experienced in FY2017 or its projected net loss for FY2018, it represents the most reasonable "going in" rate adjustment in light of the forecasts provided in Appendix A, particularly given that, as a practical matter, the supplemental rate authority will not go into effect until FY2019 at the earliest because of the pendency of these proceedings. It is, in short, the most reasonable assessment of the level of net loss the Postal Service would otherwise be

[162] *See* Appendix B.

expected to face when the new system goes into effect, and therefore represents a reasonable "going-in" adjustment for purposes of resetting the market-dominant rate baseline.[163]

Of course, nothing in Order No. 4258 actually takes (let alone supports) the position that $2.7 billion is a reasoned expectation of the net annual losses the Postal Service would be expected to suffer in any of the next five years under the current system. Because the Postal Service's "future financial position will be affected by a multitude of influences," the Commission explains, "it is not possible to precisely calculate the exact amount of additional pricing authority that will achieve medium-term stability in future years."[164] Such precision is not necessary, the Commission rationalizes, because the purpose of the supplemental rate authority is not to allow the Postal Service to cover costs as in the pre-PAEA "break-even regime,"[165] but merely to place it "on the path" to the ultimate destination of "generating positive net income."[166] According to the Commission, whether the Postal Service actually arrives at that destination will depend on whether the Postal Service can "achieve cost reductions and operational efficiency gains sufficient to close the gap between total revenue and total costs."[167]

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[163] The above-mentioned proposals to exclude the exigent increase and the FY2013 PIHOP accounting adjustment are straightforward and reflect the accrual of revenue not relevant to the creation of a going-in rate baseline. There is no basis to make further adjustments to volumes or costs over these periods. Such other adjustments are unnecessary to create a representative baseline, and making them would be an unduly complicated and subjective exercise.

[164] Order No. 4258 at 41.

[165] *Id.* at 41.

[166] *Id. at* 40.

[167] *Id. at* 43.

While it is true that financial stability cannot be forecast with absolute precision and that the Postal Service is responsible for continued aggressive management to ensure cost savings within its control, that does not excuse the Commission from making a good-faith effort to determine what baseline rate level is reasonably likely to provide net income in light of realistic cost-saving opportunities. As such, the Commission's reasoning perfectly illustrates the problem with its choice of an artificially low baseline. Not only is the Commission's stated goal in these proceedings the ultimate achievement of net income in most or all years ("medium-term stability"), it is also to allow the Postal Service to start generating enough surplus revenue to replace certain capital assets, and pay off $15 billion in outstanding Treasury debt ("long-term stability"). To do those things, the Postal Service must go beyond covering its costs and actually have the authority to generate sustained profits. If the Postal Service's "going in" rates were to produce an additional $2.7 billion of revenue against a reasonably expected net loss of $6.0 billion, then the Postal Service would need to implement at least $3.3 billion in first-year cost savings, and then sustain such savings into each subsequent year (even ignoring for the moment the factors that will cause the net-income gap to widen over time), just to tread water.

At this point, Order No. 4258 runs headlong into the record at hand. Not only is the general magnitude of potential cost-saving opportunities knowable, it is actually before the Commission in the form of the report prepared by Alvarez and Marsal (A&M), which conducted a comprehensive expert assessment of the Postal Service's operations, and discussed the scope and magnitude of the cost savings opportunities currently available to the Postal Service under existing service levels.[168] The A&M report shows that, while the Postal Service has been aggressive in pursuing opportunities to achieve cost reductions and efficiency gains, and will continue to do so, the opportunities for further cost savings come nowhere close to filling the net-income gap that Order No. 4258's proposal would leave open.

Specifically, the A&M report concluded that, setting aside potential cost-savings opportunities that are outside management's control because they require labor, regulatory, and/or political consensus, the Postal Service could conceivably remove approximately $3.9 billion from its cost baseline over the course of FY2017-FY2021, averaging less than $0.8 billion in annual cost savings.[169] Moreover, A&M uncovered no wholly new cost-savings opportunities that postal management has so far overlooked. Rather, the $0.8 billion in available annual cost savings within the Postal Service's control reflects the continuation or modification of cost-savings initiatives already in process, and thus such cost savings are incorporated, at least in part, in the calculation of the annual net losses that the Postal Service is already suffering.[170] And to the extent that the FY2018 IFP can serve as at least a one-year reference point, its aggressive cost-savings goal is likewise far below the level needed to make up for the

[168] *See* USPS March 20 Comments, appx. C.

[169] *Id.*, appx. C at 4-5. This quantification includes only opportunities that A&M identified as meeting a $100 million threshold. Other opportunities were identified but not quantified, either because they did not meet this threshold or because they could not be accurately quantified due to data and time constraints. *Id.* at 5 fn.9. It should be emphasized that that cost-savings estimate means that costs would be $0.8 billion lower than they otherwise would (all else equal) in each year of the report's five-year projection, not that the cost savings would compound by an additional $0.8 billion per year.

[170] As noted above, moreover, the forecasts in Appendix A assume that the Postal Service will through continued aggressive management achieve a high proportion of the cost savings opportunities within management control that the A&M Report discusses, in order to capture the potential reduction in work-hours arising from reduced mail volumes.

inadequacy of the Commission's proposal. In fact, those cost savings are expected only to counter inflationary pressures, not to close the net income gap.[171] By any available measure, the amount of cost savings potential is far short of the amount needed to close the gap caused by the proposal's artificially low baseline, let alone to respond to changes that could cause the Postal Service's financial situation to degenerate over the next five years.

Order No. 4258 does not even acknowledge the A&M report – the only record evidence on this issue – much less explain how the initial net-income gap left by the Commission's proposed baseline (even before accounting for the effects of volume declines and other exogenous forces in the coming years) can be made up through management efficiency initiatives that are significantly greater than the A&M's estimate of what is available to the Postal Service and within management's control. To the contrary, nothing in the record or in the FY2018 IFP suggests that the Postal Service can make up a revenue gap of more than $3 billion annually through cost-savings initiatives.

If the goal of the supplemental rate authority is to give the Postal Service "the opportunity to generate additional revenue to cover its obligations"[172] and thereby afford it an opportunity to achieve "medium-term stability," then it is true that the additional revenue from the proposed 2 percentage points of supplemental rate authority would place the Postal Service "on the path" to that goal, but only in the very limited sense that

[171] The IFP projects a $5.2 billion net loss after planned cost savings: slightly higher than the FY2017 net loss without the non-cash workers' compensation liability adjustment. U.S. Postal Serv., FY2018 Integrated Financial Plan at 3.

[172] Order No. 4258 at 38.

it is better than nothing. All other things being equal, it would allow the Postal Service's net losses to be smaller over the next five years than they would be absent such authority.[173] But objective 5 demands more than simply smaller losses: revenues must be "adequate . . . to maintain financial stability." And objective 8 requires rates to be "reasonable," which requires that they be compensatory. To fulfill those objectives, the Commission must not merely allot some meager additional sum and leave the Postal Service to fend for itself. Rather, it must make a determination as to what amount is "adequate" and "reasonable" in covering expected costs over the next several years. That, in turn, calls for an evidence-based assessment of reasonable cost-saving opportunities that would allow the Postal Service to close any net-revenue gap that is left open by a recalibrated rate level. Order No. 4258 leaves that necessary task unfinished, but record evidence and an appropriately robust analysis of historical financial-loss data support a baseline "going-in" rate increase that would require double the amount of supplemental authority than what the Commission's proposal would allow.

In short, Order No. 4258's proposed supplemental rate authority would produce an artificially low "going in" rate level. Its inadequacy would be compounded by Order No. 4258's failure to identify any way that the Postal Service can close the gap through cost cutting. As a result, the Commission's proposal ensures that the Postal Service will not come close to achieving "medium-term stability." The proposal will necessarily also mean that the Postal Service will lack any opportunity to seek the generation of retained

[173] *See* Appendix A (comparing projected net losses under a CPI cap with and without the 2 percentage points of supplemental rate authority).

earnings, even if it were to receive the proposed performance-based rate authority, as addressed in section V.A below. The Commission should establish a baseline "going-in" rate increase that would offset a net loss of $6.0 billion annually, and should therefore set the supplemental rate authority for the Postal Service for the next five years at CPI plus 4.0 percentage points of additional rate authority.

B. The Commission Should Adjust the Cap to Account for Factors That Will Materially Impact the Postal Service's Ability to Achieve Net Income

The artificially low initial baseline alone would render the Postal Service unable to close the net-income gap. But correcting that mistake is not enough to achieve objectives 5 and 8. Even if the Commission recalibrated the baseline to match a reasonable net-loss figure as discussed above, the Commission's proposal would continue to be inadequate and unreasonable overall, because the net-income gap is expected to widen over time. The Commission's proposal (like the original PAEA system itself) fails to address the fact that the ratemaking system exists within a broader statutory structure that ultimately places many of the most significant elements of Postal Service costs outside of its control. The proposal likewise fails to address the known forces that will almost certainly exert downward pressure on contribution and upward pressure on costs during the new system's term. Instead of replacing the PAEA's inflation-based formula with a system flexible enough to appropriately accommodate changing circumstances, the proposal retains the same rigid CPI-based formula, and thus repeats the current system's failures.[174]

At the very least, any new price cap must contain some kind of adjustment factor to account for ongoing mail-volume decline and network growth, the primary drivers of the large net losses that the Postal Service suffered under the PAEA. In addition, the price cap should be adjusted to account for changes in amortization and normal-cost payments needed to fund health-care and retirement programs, because such changes are predictable, recurring non-operational costs that are essentially outside the control of Postal Service management.

These problems cannot be avoided by assuming that the Postal Service can simply counteract those growing financial pressures through cost-cutting. As explained in section IV.A above, the record demonstrates that the reasonable cost-cutting opportunities available to the Postal Service are inadequate to offset even the losses produced by the Commission's artificially low baseline. They accordingly cannot even begin to offset any net-loss growth over the ensuing five-year period. Unless the Commission's proposal is revised to account for such factors, it will almost certainly leave the Postal Service farther from "medium-term stability" in five years than it is now.[175]

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[174] *See* USPS March 20 Comments at 90, 99-100 (explaining how the assumptions about the Postal Service's ability to survive the PAEA's original CPI-based cap amid inexorable delivery-point growth did not hold up to post-PAEA volume declines and mail-mix changes); APWU March 20 Comments at 29 (same).

[175] *See* Appendix A (showing that, even under an optimistic mail-volume forecast, the Commission's supplemental rate authority proposal will result in growing annual net losses and will wipe out cash on hand).

1. The Commission should adjust the price cap to account for changes to economies of density (changes in volume, the mail mix, and the delivery network)

As the Postal Service discussed at length in its March 20 Comments, the primary source of the net losses that the Postal Service suffered in each year of the PAEA era was a decline in economies of density. This was itself caused by a combination of steep mail volume declines, a shift in the mail mix away from higher-contribution mailpieces (like First Class Mail), and a consistent increase in the number of delivery points per year.[176] Congress can perhaps be excused for failing in 2006 to foresee the need to account for such a decline and for instead expecting that changes in postal expenses and revenues would continue to track changes in CPI.[177] After all, at that time, mail volume was still increasing, and the Postal Service's revenues and total costs were both still more or less in line with inflation. But the Commission, knowing what it knows now, has no such excuse.[178]

The Commission could account for those known and ongoing factors through the use of a formula that would adjust the price cap to authorize the Postal Service to offset the erosion of its net income due to declining economies of density. This would shore up the new system's chances of achieving objectives 5 and 8, and would sustain market-dominant products' ability to cover an appropriate level of institutional costs (objective 9). The most comprehensive formula to address those factors is a "hybrid

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[176] USPS March 20 Comments at 9-11, 91-100.

[177] Order No. 4257 at 37-38.

[178] Order No. 4258 at 42 ("Market dominant product volumes have been declining overall and shifting toward lower-priced products and rates."); *id.* at 54 (same); Order No. 4257 at 38-41, 167-68, 200.

cap" proposed in a 2013 report by the U.S. Postal Service Office of the Inspector General, in conjunction with Christensen Associates.[179]

The hybrid cap formula would adjust the price cap to allow the Postal Service to recover through pricing the contribution to institutional costs that is lost due to declines in mail volume and changes to the mail-mix, as well as to offset increased institutional costs caused by growth in the delivery network. The formula itself is straightforward:

> **Total % Δ in Rate Authority = [Baseline Rate Authority] – [Share of Institutional Costs × (% Δ in Revenue-Weighted Volume – % Δ in Number of Delivery Points)]**

In this formula, "[Baseline rate authority]" represents CPI-based, unused, supplemental, underwater-class, and capital-funding/performance-based rate authority.[180] The rest of the equation reflects the degree to which that baseline rate authority must be adjusted to maintain the ability to achieve net income. Put another way, it accounts for any change in the Postal Service's ability to cover institutional costs caused by the factors described above: changes in mail volume, mail mix, and the delivery network.

Specifically, the "% Δ in revenue-weighted volume" figure (1) multiplies each market dominant product's absolute change in volume (over the immediately preceding

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[179] U.S. Postal Service Office of the Inspector General, Revisiting the CPI-Only Price Cap Formula, Report Number: RARC-WP-13-007 (Apr. 12, 2013) (OIG Report).

[180] In the original expression of this formula, the first variable was the percentage change in CPI. *See* OIG Report at 16. Christensen expressly assumed that rates would be set at a reasonable level before prospective application of the CPI-with-adjustment formula. USPS March 20 Comments, appx. E at 29-30; *accord* OIG Report at 8, 22-23, 26. To achieve a comparable result here, the baseline for adjustment should include not only CPI-based rate authority, but also supplemental rate authority and underwater-product rate authority, which aim at the rate-resetting that Christensen identified as a necessary precondition. Any capital-funding or performance-based rate authority would also be aimed at providing a reasonable rate level, and so that authority should be included in the baseline as well to guard against erosion in its value.

year) by that product's share of total market-dominant revenue in the current year, and (2) adds together those individual totals. The resulting figure accordingly accounts not only for the impact on revenue of volume changes overall, but picks up volume changes, price changes, and revenue shares for each product, and thus accounts for changes to the mail mix.[181] The "% Δ in number of delivery points" figure, meanwhile, accounts for the fact that the size of the delivery network increases every year primarily because of population growth, economic growth, and the universal service mandate, which translates into increases to the Postal Service's base of institutional costs. Then, after subtracting the percentage change in delivery points from the percentage change in constant dollar revenue, the difference is multiplied by the "share of institutional costs," *i.e.*, the percentage of total costs that are not attributable to products and thus that generally do not change when volume declines.[182]

To take a simple hypothetical example from the OIG report,[183] if the Postal Service's revenue-weighted volume declines by 1.9 percent in a given year on a constant-dollar basis, its number of delivery points grows by 1.1 percent in that year, and its share of institutional costs is 45.31 percent in the most recent year in which such data is available, then the baseline authority would be adjusted upward by 1.36 percentage points in the following year to make up for the lost economies of density:

[181] As the OIG Report notes, "[u]sing constant dollar revenue, rather than the raw volume data, accounts for the fact that different types of mail bring in different amounts of revenue per piece." OIG Report at 15 fn.47. If each market dominant product had the same price, the same volume, and the same change in volume, the change in revenue-weighted volume would be equal to the total change in volume.

[182] Accepted measures for these inputs are publicly available. For example, delivery network growth can be obtained from publicly filed TFP data, and the share of institutional costs is developed and reported in the annual compliance review.

[183] *See* OIG Report at 16.

[Baseline rate authority] – [Share of Institutional Costs × (% Δ in Revenue-Weighted Volume – % Δ in Number of Delivery Points)]

= [Baseline rate authority] – [.4531 × (–1.9 –1.1)]

= [Baseline rate authority] – [.4531 × (–3.0)]

= [Baseline rate authority] + 1.36

That adjustment to the baseline rate authority would give the Postal Service the authority to recapture the net contribution to institutional costs that was lost as a result of volume declines and network growth, and therefore would help correct the fundamental flaw of the original CPI-based model: that because pricing was tied strictly to the rate of inflation, the Postal Service was unable to generate sufficient unit revenue from the mail volume remaining in the system to account for the higher unit costs of that volume.[184]

2. The Commission should adjust the cap for changes in pension and RHB payments

The Commission must also account for changes in the Postal Service's pension and RHB liabilities. Those liabilities, which translate into annual normal cost and amortization expenses and cash payment requirements, are exogenous costs. The

[184] An alternate approach to accounting for volume loss is found in the Public Representative's March 20 Comments, proposing an adjustment to CPI based on a mechanism originally developed by economists Timothy J. Brennan and Michael A. Crew. *See* Public Representative March 20 Comments at 50-56 (citing Declaration of Timothy J. Brennan, PRC Docket No. RM2017-3 (Mar. 20, 2017) ("Brennan Declaration")). This formula does not account for revenue-weighted volume changes or changes in institutional costs due to delivery-point growth. But like the hybrid cap, it acknowledges that volume declines vitiate the Postal Service's ability to cover institutional costs, and addresses that problem by adjusting the price cap. It further recognizes elasticity effects, and adjusts for such effects in the interest of yielding a compensatory amount of revenue. *See* Brennan Declaration at 17-18. Accordingly, if the Commission is not inclined to accept the proposal above, it should at least implement this alternative endorsed by the Public Representative. That said, the Postal Service disagrees with the Brennan Declaration's proposal to use <u>revenue</u> from Market Dominant volume as the basis for deriving the elasticity of cost, an input to the formula. As discussed above, market-dominant rates are presently non-compensatory, so revenue from Market Dominant volume does not properly represent its total cost.

Postal Service is required by statute to make the payments, and the amounts themselves are a function of legal requirements.[185] The amounts are also extremely sensitive to changes in the assumptions used by the Office of Personnel Management's (OPM's) Board of Actuaries: for example, a 50-basis-point change in the discount rate and an unexpected change in cost-of-living adjustments caused the Postal Service's CSRS liability to spike by $17.5 billion in FY2011, single-handedly turning a surplus into a deficit to be amortized.[186] Those actuarial assumption changes are outside of the Postal Service's control.[187]

The Postal Service's pension and RHB costs are not equivalent to costs incurred by the average firm in the broader economy. The PAEA requires the Postal Service to prefund 100 percent of its RHB and pension liabilities; actual funding levels were 44 and 86 percent, respectively, in FY2017.[188] By contrast, only 59 to 99 Fortune 1000 companies (6 to 10 percent) prefunded RHB at a level comparable to the Postal Service in 2013; 833 (67 percent) either were not liable for RHB or did not prefund at all.[189]

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[185] *See* Order No. 4257 at 157-58 (citing 39 U.S.C. § 1005(d)(1) and (f)).

[186] *Compare* U.S. Postal Serv., FY2012 Form 10-K (2012), at 38-39 (showing actuarial accrued CSRS liability of $210.8 billion as of the end of FY2011, based on economic assumptions that OPM employed to compute the liability during FY2012) *with* U.S. Postal Serv., FY2011 Form 10-K (2011), at 26 (projecting a FY2011 actuarial accrued CSRS liability of only $193.3 billion, based on then-prevailing economic assumptions).

[187] Although the Postal Service can ask the OPM Board of Actuaries to reconsider certain aspects of the liability calculations, *e.g.*, 5 U.S.C. § 8909a(d)(5); 5 C.F.R. §§ 841.415-.417, it has no power to compel a different result. And while, at least for current and future employees, RHB (but not pensions) might theoretically be subject to modification without legislative change, the Postal Service's ability to make such changes is constrained by collective bargaining and binding arbitration. 39 U.S.C. § 1005(f).

[188] U.S. Postal Serv., FY2017 Form 10-K at 26, 28, 31.

[189] Towers Watson, Fortune 1000 Companies Have a $285 Billion Liability for Retiree Medical (Nov. 2014), http://tiny.cc/TW-F1000-RHB. The number of companies prefunding at a comparable level is presented as a range because the prefunding tiers in the source article do not allow for a more precise comparison.

State governments, in the aggregate, prefunded 6.9 percent of their RHB liabilities in 2015,[190] and the Department of Defense prefunded 28.9 percent of its liability in FY2017.[191] It should be noted that these employers prefund at such low levels even after net liabilities have been reduced through measures such as Medicare integration and diversified asset portfolios; such measures are off-limits to the Postal Service. The Postal Service must also prefund 100 percent of the liabilities for two very costly defined-benefit pension plans, the parameters of which are wholly outside of its control. Thus, the Postal Service has far more exposure than most other employers to RHB and pension liability changes, and economy-wide measures like CPI cannot fairly be considered a reasonable proxy. Even if the Commission properly adjusts the Postal Service's rate base as discussed in section IV.A above, such an adjustment will account for the revenue needed to cover pension and RHB payments as of FY2017, but will not account for situations where such obligations increase or decrease.[192]

Accordingly, the Postal Service proposes a simple solution, modeled on "cost trackers" that regulators often use for volatile expenses,[193] which would account for

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[190] Pew Charitable Trusts, State Retiree Health Care Liabilities: An Update (Sept. 2017), http://tiny.cc/Pew-State-Gov-RHB. Twenty states either did not prefund RHB at all or did so by less than 1 percent. Only eight states prefunded at least 30 percent.

[191] U.S. Dep't of the Treasury, FY2017 Financial Report of the United States Government (Feb. 15, 2018), at 95, 98 (reporting FY2017 Medicare-Eligible Retiree Health Care Fund assets of $225.8 billion and accrued actuarial RHB liability for military beneficiaries of $781.6 billion).

[192] Unlike the adjustment factor for economies of density, which will very likely cause an upward adjustment to the price cap, it is foreseeable that the benefits adjustment could reduce the Postal Service's pricing authority. For example, if Congress were to pass legislation that altered the Postal Service's benefits obligations, an adjustment factor would have the effect of reducing the Postal Service's rate authority, just as an adjustment factor should increase the Postal Service's authority if such obligations increase over time.

[193] *See* Mark Newton Lowry *et al.*, *Alternative Regulation for Emerging Utility Challenges: 2015 Update*, Edison Electric Institute (2015), at 6, http://tiny.cc/Newton-Lowry-et-al-AltReg (noting that cost trackers are often used for "volatile" expenses such as "those for pensions," for "costs incurred due to policies of government agencies," and for "costs that are rapidly rising and don't otherwise trigger new revenue").

annual changes to pension and RHB payments by resetting the baseline rate level authority every year. Specifically, the price cap should be adjusted by the total change in retirement costs – *i.e.*, year-over-year changes to RHB and FERS normal cost payments, and to amortization payments for RHB, FERS, and CSRS benefits – divided by total market-dominant revenue.[194] For example, if such retirement costs grow by $0.5 billion in a given fiscal year and overall market-dominant revenue is $50.0 billion for that year, the Postal Service would be able to recoup such exogenous cost growth in the following year through a one-time upward price adjustment of 1.0 percentage point (= $0.5 billion / $50 billion) for that year. Conversely, if pension and RHB expenses instead shrank by $0.5 billion, there would be a one-time, 1.0 percentage point downward adjustment in the following year.[195]

C. Correction of the Supplemental Rate Authority Proposal Does Not Signify a Return to Cost-of-Service Ratemaking or Discourage Cost Cutting

The Postal Service remains deeply skeptical of any price cap's ability to achieve the statutory objectives in light of the statutory factors. However, if the Commission intends to try to achieve objectives 5, 8, and 9 within a price cap framework[196] it must design a system that will actually make total-cost coverage achievable in practice. The

Capital trackers are discussed further in section V.B.3 below. Although capital trackers are often conditioned on *ex ante* prudence review, there is no need to do so in this context, where the relevant cost changes are not a function of Postal Service management.

[194] Total Market Dominant Revenue is intended to be the same figure that underlies the Commission's Supplemental Rate Authority at Order No. 4258 at 43.

[195] In reality, elasticity effects would mean that a 1.0-percentage-point upward adjustment would yield less than $0.5 billion in revenue, and *vice versa*. If the Commission does not adopt a factor to adjust rate authority for revenue-weighted volume changes, as proposed in the previous section, then any factor to recover pension and RHB cost changes should be adjusted for elasticity effects, in the interest of yielding a compensatory amount of revenue, as intended.

[196] Order No. 4258 at 39; Order No. 4257 at 165.

proposals set forth above would at least be more effective than the Commission's approach in solving some of the key problems that the Commission rightly identified in Order No. 4257. It remains to be seen whether making those fixes will actually be sufficient to allow the Postal Service to cover its total costs. But the modifications would at least eliminate the obvious flaws in the new system's design. A reasonably adequate baseline, coupled with rational adjustments for known factors outside of the Postal Service's control, would make good on the Commission's intent to put the Postal Service on a meaningful "path" to financial stability.

To be clear, however, the above alterations do not signal a return to cost-of-service ratemaking any more than the Commission's proposal signals such a return. The Commission's proposal, even with the Postal Service's modifications, is self-evidently a price cap modeled on the current system. It would set a ceiling on the Postal Service's pricing authority, rather than seeking a thorough, bottom-up evaluation of Postal Service costs to build a revenue-requirement forecast, as under cost-of-service regulation. And like price cap systems outside of the current CPI-only postal price cap, it would be calibrated with the express aim of covering the costs of universal service.[197] After the theoretical initial calibration (smoothed over five years) and adjustments for specific exogenous sources of volatility, the Postal Service would have

[197] *See* section III.A *supra* (summarizing record submissions about cost-responsiveness in price-cap practice). Scholarly literature affirms the need for price caps to be cost-responsive. *See also* Declaration of John Kwoka, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 12 ("[P]lans generally provide for longer-term periodic reviews of performance to make any 'mid-course corrections' in the price index or in the X, Y, or Z factors. As I have noted, these adjustments help restore correspondence between price and costs and thereby lengthen the period of time of acceptable plan performance."); Public Representative Comments, PRC Docket No. PI2016-3 (June 15, 2016), at 42-43 (summarizing academic literature to the effect that "a price cap must operate with a breakeven constraint" in order to "extract[ ] more rents for consumers in the long run," hence a "need to provide periodic revenue reset adjustments" (citation, internal quotation marks, and capitalization omitted)).

to keep operating expenses within CPI in order to be profitable. In no way do these features bespeak a violation of price cap principles.

Moreover, the Postal Service will not lack incentives to reduce costs in the coming years, even if it were given more pricing authority. Amid long-term, rapid demand erosion, the Postal Service knows as well as anyone that financial stability cannot come through pricing alone, and does not advocate for a system that the Postal Service can price its way to profitability. The Postal Service will still need to be aggressive in adjusting workhours to continued volume declines, seeking further cost reductions through collective bargaining and other measures, and educating Congress on the need to reform the Postal Service's disproportionate long-term liabilities and other statutory constraints.[198] At the same time, the Postal Service maintains that any system – including the system that it proposed in its comments of March 20, 2017, and proposes again in section III above – must, in order to achieve the objectives, be designed to ensure that the Postal Service has a meaningful opportunity to achieve stability so long as it is taking appropriate steps to manage its business responsibly.

Finally, and perhaps most importantly, the mere authorization of additional pricing flexibility by no means suggests that the Postal Service will necessarily use all of the authority it is given. Its actual pricing decisions will be informed by changes in demand and by other market forces, which alone impose adequate real-world incentives to increase efficiency and reduce costs in an increasingly challenging environment. All the Postal Service seeks here are the tools to maintain a financially viable, high-quality universal service amid known and unknown challenges in the years to come. The

[198] *See* section III.D *supra*.

current system did not provide those tools. Neither can the new system, so long as the Commission follows through with its proposal of retaining the rigidities that caused the current price cap to fail.

V. THE PERFORMANCE-BASED RATE AUTHORITY, AS PROPOSED, WILL NOT FULFILL ITS PURPOSE OF FUNDING CAPITAL INVESTMENT IN EFFICIENCY AND SERVICE IMPROVEMENT

The Commission is correct that, for the Postal Service to be financially stable over the long term, it is not enough that it break even over time. It must also be profitable "year after year, thus building up retained earnings that would allow the Postal Service to invest in capital improvements and pay down debt."[199] The Postal Service must also have enough liquid assets available to service its current liabilities and maintain operations through a financial emergency; this requires the generation of surplus cash in the form of retained earnings.[200] The Postal Service's trajectory from $3.2 billion in retained earnings to a $61.9 billion deficit is a testament to the current system's gross failure.[201] To remedy the retained earnings problem, the Commission proposes an additional 1 percentage point of pricing authority on top of CPI-based and supplemental rate authority (which are ostensibly aimed at giving the Postal Service an opportunity to cover its total costs each year, and no more).

Unfortunately, the Commission's proposal is at tension with its own stated purposes. The additional 1 percentage point of pricing authority will not produce any retained earnings unless the supplemental rate authority is revised to give the Postal

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[199] Order No. 4257 at 169.

[200] As discussed in section II.C.1 above, the Commission has not answered the question of whether the Postal Service's liquid assets are "adequate" to "maintain [short-term] financial stability."

[201] Order No. 4257 at 171; U.S. Postal Serv., FY2017 Form 10-K at 46.

Service a meaningful opportunity to cover its costs. Even if that problem were solved, the Commission's proposal to condition the additional 1 percentage point on productivity growth and service standards maintenance is diametrically opposed to the Commission's acknowledgment that the Postal Service needs more capital to invest before it can significantly improve performance. And the specifics of the performance incentive mechanism's (PIM's) proposed efficiency component, which would determine the majority of the performance-based rate authority, would almost certainly render it unachievable, and thus ineffective, for most or all of the initial five-year period.

Some more significant correction is needed to remedy the current system's failure to achieve objectives 1, 3, 5, and 8. The simplest solution, consistent with the statutory objectives and regulatory practice, would be to make the additional rate authority unconditional. That would ensure a predictable, stable stream of capital to fund investments in efficiency, service, and mail security, the efficacy of which could be assessed in the next Section 3622(d)(3) review. If the Commission is nevertheless committed to conditioning a portion of the rate authority on operational efficiency performance, that component should be revised to render it achievable and consistent with regulatory best practices concerning PIMs.

A. The Performance-Based Rate Authority Will Not Fulfill Its "Retained Earnings" Purpose Without a Meaningful Level of Supplemental Rate Authority

Before addressing the flaws with the performance incentive mechanism itself, there is a threshold issue of how the performance-based rate authority relates to the supplemental rate authority. The performance-based rate authority is designed as a needed bridge between total cost coverage (i.e., "medium-term stability") and profitability (i.e., "long-term stability"), and therefore presupposes that the Postal Service is already covering its total costs. However, the Postal Service cannot cross that bridge until it is actually covering its costs. As discussed in section IV, the Commission's proposed supplemental rate authority will not come close to allowing the Postal Service to cover its costs over the next five-year period, unless it is modified in a fashion consistent with these comments.

Unless the proposed supplemental rate authority is modified to set a compensatory baseline rate level for the new system, as described in the previous section, then the proposed performance-based authority will necessarily not allow the Postal Service to generate retained earnings (even if the Postal Service could qualify for such authority), and thus will not achieve objective 5. Accordingly, one benefit that the Commission anticipates the performance-based authority will produce – investments in capital improvements – will be realized only if the Postal Service determines that it can make such investments even while continuing to amass annual net losses, which in turn would mean that another anticipated benefit produced by such performance-based authority – the repayment of debt – will never be realized. Given that the Commission has stressed the importance of positive net earnings, it is all the more important that it fix the flaws with its proposed supplemental rate authority before tackling the issue of insufficient profitability.

B. The Proposed Performance-Based Rate Authority Must Be Made Unconditional in Order to Achieve Its Purpose of Starting the "Harmonious Cycle" Identified in Order No. 4258

1. By confusing two distinct regulatory concepts, Order No. 4258 sets up a catch-22

Even if the Commission properly addresses the problem of total cost coverage, the conditional nature of the Commission's proposed performance-based rate authority is at odds with the Commission's stated rationale. According to the Commission, the problem with the lack of retained earnings (which are generated by revenues sufficient to produce net income) is that it prevents the Postal Service from taking advantage of a "harmonious cycle."[202] As the Commission describes, the cycle operates when the Postal Service generates adequate revenue to accumulate retained earnings, with which it can make capital investments that increase operational efficiency and maintain service quality; those improvements eventually lead to increased revenues and reduced costs, which can produce more retained earnings for further investment.[203] However, the Commission notes that the "cycle begins with the path to financial stability,"[204] and finds that the Postal Service could not access the cycle "under the existing ratemaking system because consecutive net losses have resulted in an accumulated deficit rather than retained earnings."[205]

The solution seems obvious enough: the Postal Service needs additional revenue so it can take the path to the harmonious cycle, which would then allow it to increase operational efficiency. And the Commission does purport to authorize additional rate authority. But there is a catch. The Postal Service can qualify for the additional rate authority only if the Postal Service shows efficiency gains first. This condition completely undermines the Commission's analysis. If the Commission's position is that additional revenue is needed to enable the Postal Service to make investments that might improve operational efficiency, then it makes no sense to

[202] Order No. 4258 at 46-47.

[203] *Id.* at 35-37, 46-47.

[204] *Id.* at 46 (emphasis added).

[205] *Id.* at 47.

withhold additional rate authority until after the Postal Service has improved operational efficiency, which – according to that same Commission position – the Postal Service cannot do without the additional revenue. Inadequate capital investments are a bar to improvement, but the solution cannot be to withhold investments until after improvement happens. "Such Catch-22 thinking is the antithesis of reasoned decisionmaking."[206]

The internal conflict stems from the fact that the Commission's proposed performance-based rate authority is trying to do too much at once. Its chief purpose is to provide a stream of revenue to fund needed capital investments.[207] As discussed further in section V.B.3 below, dedicated capital-funding mechanisms are well-established in regulatory practice, including as adjuncts to price caps. To the extent that such mechanisms are conditional, however, that condition typically takes the form of a cost-of-service-style *ex ante* prudence review, rather than the Commission's proposed requirement that the benefits of the investment appear before the investment itself is made.

Apparently not trusting that investment alone is sufficient to improve operational efficiency and maintain high-quality service standards, the Commission proposes to graft performance conditions onto the rate authority. But the namesake for the Commission's proposal represents a very different regulatory mechanism. PIMs are typically used to incentivize a "regulated entity . . . subject to cost-cutting pressures"[208]

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[206] *Cross-Sound Ferry Servs., Inc. v. Interstate Commerce Comm'n*, 738 F.2d 481, 487 (D.C. Cir. 1984).

[207] Order No. 4258 at 46-54.

[208] *Id.* at 55-56 (citing Mark Newton Lowry & Tim Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future*, Lawrence Berkeley National Laboratory, Report No. 3 (2016), http://tiny.cc/Newton-Lowry-Woolf-paper, and Melissa Whited et al., *Utility Performance Incentive*

nevertheless to take costly actions in preferred policy areas, such as employee safety, customer service, or reliability (where it might otherwise seek to cut costs to live within the cap) and promotion of energy conservation (which decreases demand).[209]

As discussed in section II.C.2-.3 above, however, the Commission has not established that any decline in operational efficiency growth rates or reduction in service standards resulted from incentive design, rather than operating conditions that impact TFP trends or a lack of adequate capital investment (or, in the case of service standards, the operation of other objectives and factors made relevant by Section 3691). With respect to operational efficiency in particular, it is hard to see how a price cap, especially one as inflexible and non-compensatory as the current system, would incentivize a regulated firm to underinvest in efficiency, as it might in the areas traditionally addressed by PIMs. As one of the scholarly sources cited by the Commission points out, while "[i]mportant areas of utility performance such as general cost containment could in principle be addressed by PIMs, [they] typically are not."[210]

In an echo of other price cap regulators' capital-funding mechanisms, the Commission has established the need for additional capital to invest in infrastructure.

Mechanisms: A Handbook for Regulators, Western Interstate Energy Board (2015), http://tiny.cc/Whited-et-al-Paper).

[209] *See* Mark Newton Lowry & Tim Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future*, Lawrence Berkeley National Laboratory, Report No. 3 (2016), at 4, 13-15, 18, 23-24, http://tiny.cc/Newton-Lowry-Woolf-paper (energy efficiency and accommodation of distributed energy resources); Mark Newton Lowry et al., A*lternative Regulation for Emerging Utility Challenges: 2015 Update*, Edison Electric Institute (2015), at 35, http://tiny.cc/Newton-Lowry-et-al-AltReg (service quality); Melissa Whited et al., *Utility Performance Incentive Mechanisms: A Handbook for Regulators*, Western Interstate Energy Board (2015), at 1, 6, 12-13, http://tiny.cc/Whited-et-al-Paper (reliability, safety, energy efficiency, and distributed energy resources); William P. Zarakas & Philip Q Hanser, *Targeted Performance Incentives: Recommendations to the Hawaiian Electric Companies* (2014), at ii, 2, http://tiny.cc/Zarakas-Hanser-paper (reliability and customer service).

[210] Mark Newton Lowry & Tim Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future*, Lawrence Berkeley National Laboratory, Report No. 3 (2016), at 4, http://tiny.cc/Newton-Lowry-Woolf-paper.

However, the Commission has not established an incentive problem to be solved through a PIM. In setting out to do two very different regulatory tasks at once, the Commission's proposed PIM fails in both respects.

2. TFP growth is an inappropriate metric for this purpose

The Commission's particular choice of TFP growth as a performance condition – as the predominant one, no less – only accentuates the "harmonious cycle" problem. Going into the new system, TFP is weighted down by past underinvestment and the increasingly limited opportunities for future efficiency improvement within statutory constraints. And then there are the ongoing headwinds of delivery-point growth and the shift in the mail mix toward higher-cost products. The Commission's approach does not seriously address the scale of the problem, let alone how the Postal Service would be expected to fund the necessary increase in capital outlays before the additional rate authority is made available.[211] A number of factors beyond the Postal Service's control pose real challenges to TFP growth in the near term, regardless of regulatory incentives.

To the extent that TFP picks up efficiency-promoting effects of capital investments (as envisioned by the "harmonious cycle" rationale), those effects can be substantially offset by other resource-usage trends. The last few years provide a vivid example: the rate of TFP growth slowed and even went negative in FY2014-FY2016, even as the level of annual capital commitments and outlays rose.[212] But even if those

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[211] *See* Order No. 4258 at 61 ("Using a performance-based approach to incentivize continued TFP growth will help incentivize the Postal Service to overcome the challenges to finding new ways to increase efficiency referenced by the Postal Service and Christensen.").

[212] *Compare* U.S. Postal Serv., Annual Tables, FY 2017 TFP (Total Factor Productivity) (Feb. 28, 2018), Microsoft Excel file "Table Annual 2017 public (2017 CRA).xlsx", tab "Tfp-52", cells K62-K64, *with* Order No. 4258 at 52 (Table III-1).

capital commitments were entirely aimed at operational efficiency and had immediate effects that offset the increase in capital-resource usage (neither of which is necessarily the case), other factors led resource consumption to outpace workload overall. For instance, the Postal Service has devoted a heightened level of resources to restoring service performance.[213] And given the organization-wide nature of TFP, it may also be responding to a reorganization of resources in response to strong (and relatively resource-intensive) package growth.[214] The comprehensive nature of TFP makes it a helpful metric when conducting a broad-based performance review,[215] but a poor fit for a mechanism aimed at restoring a "harmonious cycle" predicated solely on capital resources.

Capital is an element of the resource-usage or input component of TFP.[216] All other things equal, if the Postal Service were to invest more in capital expenditures in a given year, as the Commission intends it to do, then TFP may decline that year, as some of the benefits of the investment would tend to be realized in later years. This would not be conducive to achieving the TFP benchmark in the interest of earning more performance-based rate authority the following year.[217] Applying a TFP-based PIM in the new system's early years could have the perverse effect of disincentivizing the very

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[213] USPS March 20 Comments at 196.

[214] *Id.* at 197 fn.378.

[215] Order No. 4258 at 58; USPS March 20 Comments at 57 & appx. D at 1. In touting the benefits of TFP's comprehensiveness, the Postal Service and Christensen spoke expressly in the context of TFP's role "as an evaluation tool of management." *Id.* at 57 & appx. D at 3.

[216] *Id.*, appx. D at 3-4.

[217] Due to the weighting of different resource-usage components, capital investment might not have a large effect on the result overall. But particularly if the Commission were to use a three-decimal-place level of precision, even a small drag on TFP could be determinative.

sort of large investments that might achieve the Commission's ultimate purpose of raising TFP growth over the period.

Then there is the "harmonious cycle's" slow and uneven pace. The TFP-growth returns on efficiency-oriented investment may take some time to materialize at all, and then only gradually. Before the benefits of a capital program can be fully realized, the investment must be planned; research and development must be conducted; multiple rounds of contract selection must be undergone; equipment must be developed, tested, manufactured, rolled out, and put into service; personnel must be trained to operate the equipment efficiently; and other cost-structure adjustments must then be made to capture the resulting cost savings. In reality, even after the necessary cash has become available (such as after an increase based on additional rate authority), it can take a number of years for an investment to translate into operational results. For example, the Postal Service invested heavily in mail processing automation during the 1990s, while adapting to then growing volumes of letter mail; from FY1990-FY1999, TFP growth averaged 0.2 percent.[218] While those investments contributed to relatively high rates of TFP growth from FY2000 until the onset of the Great Recession, the full payoff in terms of TFP ultimately appear to have fallen, in part, outside a five-year window.

Finally, reducing the focus of capital investment to TFP is myopic. Many critical capital investments have no material effect on TFP, such as investments in mail-security technology, cybersecurity, and customer service. Such investments do not

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[218] *See* U.S. Postal Serv., Annual Tables, FY 2017 TFP (Total Factor Productivity) (Feb. 28, 2018), Microsoft Excel file "Table Annual 2017 public (2017 CRA).xls," tab "Tfp-52," column K.

promote cost efficiencies, but they would drag down TFP (and therefore diminish the chances of achieving the PIM) in the short term. By focusing heavily on TFP growth, the proposed PIM could incentivize Postal Service management to focus unduly or exclusively on capital investments that would promise the quickest possible results in TFP, in the interest of earning more performance-based rate authority, and to defer needed investments in mail security and other areas that would benefit the public. The shift in focus that could result from the proposed PIM would work to the detriment of objective 7, rather than ensuring that the system is "designed to achieve" it.

For all of these reasons, even if the performance-based rate authority somehow allowed for additional rate authority in the first year of the new system, capital expenditures funded from that rate authority might not translate into TFP growth until the very end of the new system's initial five-year term (or later). And that is even before considering how the Commission's proposed TFP-benchmarking method would set an unreasonably high bar to achievement of the additional rate authority, particularly in the early years that are the most critical for starting the harmonious cycle.[219] In terms of raising capital-spending levels and overall TFP growth rates across the period, the proposed PIM would have failed at either or both of its stated purposes.

3. An unconditional capital-funding mechanism would fulfill the "harmonious cycle" rationale simply and consistently with regulatory practice

The Commission would do well to follow the established regulatory model and establish a dedicated capital-funding mechanism to solve the capital-funding problem, instead of trying to enlist a counterproductive and unprecedented TFP-based PIM for

[219] *See* section V.C.1-.2 *infra*.

that very different job. Because Order Nos. 4257 and 4258 link the PAEA-era development of operational efficiency to a lack of means, rather than a lack of incentives, a means-based solution is all that is called for at this time. If, in a future review, the Commission finds that, notwithstanding adequate means, the system's incentives promoted a degradation of service below "high quality" levels or in a manner inconsistent with other policy interests, the Commission can revisit the need for a PIM at that time.[220]

It would be simple enough to adapt the Commission's proposal into an unconditional capital-funding mechanism. The Commission has already identified 1 percentage point of additional annual rate authority as an amount that would restore capital expenditures to pre-PAEA levels over a reasonably short period of time (if volume erosion were not accounted for).[221] Making that rate authority unconditional would render moot the need to fix the other problems of the proposed PIM's design, discussed in the next sections.

There is no indication that the Postal Service would waste such an unconditional capital-funding-oriented revenue stream. The Postal Service has been vocal about the

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[220] As explained in section II.C.2-.3 above, Order No. 4257 does not establish that the current system was responsible for changes in TFP-growth trends and service standards, let alone that the problem was one of incentives.

[221] Order No. 4258 at 54 ("In approximately 5 years, the proposed [1-percentage-point] performance-based rate authority would produce enough cumulative additional revenue to allow the Postal Service to replace the $7.8 billion decrease in net capital assets that occurred in the PAEA era."). If the Commission wishes to retain the proposed bifurcation of that 1 percentage point pricing authority, then at least the 0.75-percentage-point portion should be made unconditional, with the 0.25-percentage-point portion remaining conditional but achievable for most classes in most years. As discussed in section V.D below, the service standards component sets an appropriately low bar to achievement, and it is based on a simpler, clearer, and more predictable criterion than the operational-efficiency component's TFP criterion.

need for increased capital spending to maintain operational performance.[222] It is also aware that external oversight authorities, including the Commission, expect to see the Postal Service address the business risks of lagging capital investment, if given the means to do so.[223] As shown in section IV.C above, even with a reasonable level of supplemental rate authority and appropriate adjustment mechanisms, the Postal Service will not lack incentive to invest in cost-reducing infrastructure improvements and revenue-generating innovations. For most of the history of postal regulation, the Postal Service was entrusted to manage its capital budget without regulatory second-guessing as to the wisdom of investment plans; the current situation offers no reason to change that precedent.[224]

There is precedent for non-performance-based capital-funding mechanisms in a price cap system. Many regulators, including those operating in an incentive-regulation model, employ "capital trackers" to fund specific capital investment initiatives.[225]

[222] *E.g.*, U.S. Postal Serv., FY2017 Form 10-K at 10-11, 36-38, 56; *Accomplishing Postal Reform in the 115th Congress – H.R. 756, The Postal Service Reform Act of 2017: Hearing Before the House Comm. on Oversight & Gov't Reform*, 115th Cong. at 16-17, 20 (Feb. 7, 2017) (written statement of Postmaster General and Chief Executive Officer Megan J. Brennan); id. at 111-12, 115-16, 121, 123 (oral remarks of Ms. Brennan) (repeatedly discussing the need for capital to invest in revenue-generating innovations, identifying numerous areas requiring increased capital investment, and committing to "prioritize our capital spend").

[223] *E.g.*, *Accomplishing Postal Reform in the 115th Congress – H.R. 756, The Postal Service Reform Act of 2017: Hearing Before the House Comm. on Oversight & Gov't Reform*, 115th Cong. at 39-40, 56 (Feb. 7, 2017) (written statement of Commission Chairman Robert G. Taub); Gov't Accountability Office, GAO-11-386, United States Postal Service: Strategy Needed to Address Aging Delivery Fleet (May 2011), at 40-41.

[224] *See* Opposition of the United States Postal Service to Motion for Issuance of Information Request, PRC Docket No. RM2017-3 (Jan. 26, 2018), at 3-4 (summarizing Postal Rate Commission case-law). *See also id.* at 5 (recounting the Office of the Inspector General's findings that, notwithstanding some concerns, all 65 Postal Service investment decisions reviewed were "in the best interest of the Postal Service").

[225] Mark Newton Lowry *et al.*, *Alternative Regulation for Emerging Utility Challenges: 2015 Update*, Edison Electric Institute (2015), at 34, 37-46, http://tiny.cc/Newton-Lowry-et-al-AltReg (discussing the frequent incorporation of cost trackers into multi-year rate plans, and listing current and historical price

However, traditional capital trackers are subject to *ex ante* cost justification and prudence review, thus "typically represent[ing] an element of traditional, [cost-of-service regulation] imbedded within the [performance-based ratemaking] plan."[226] As such, the regulatory burden, inflexibility, and adverse incentives typical to cost-of-service regulation can follow. While the notion of a dedicated capital-funding mechanism is well-established, a traditional capital tracker would be a poor fit in the current postal regulatory context. Unlike other regulated utilities, the Postal Service is not operating from a position of solvency, such that additional capital must be scrutinized to ensure that it is non-excessive and in the public interest. Rather, the entire problem here is the longstanding deficit in capital-spending levels due to non-compensatory rates, which interfere with the Postal Service's ability to invest in improvements widely acknowledged to be not merely prudent, but overdue.

There is another, more appropriate model. In a recent decision on its second-generation price cap plan, the Alberta Utilities Commission (AUC) moved beyond reliance on traditional capital trackers, by narrowing their application to discrete contexts and introducing a more general-purpose unconditional capital-funding mechanism, which it called a "K-bar."[227] The Postal Service recommends that the Commission

caps or rate freezes with capital trackers in Arizona, California, Colorado, Florida, Indiana, Iowa, Louisiana, Maine, New Hampshire, Ohio, Virginia, Alberta, British Columbia, and Ontario).

[226] Mark E. Meitzen et al., The Alphabet of PBR in Electric Power: Why X Does Not Tell the Whole Story, 30 ELECTRICITY J. 30, 34 fn.29 (2017).

[227] *See generally* Decision No. 20414-D01-2016 (errata), 2018-2022 Performance-Based Regulation Plans for Alberta Electric and Gas Distribution Utilities (Alberta Util. Comm'n Feb. 6, 2017), at ¶¶ 178 *et seq.*, http://tiny.cc/AUC-20414-D01-2016. While the Postal Service believes that much of the AUC's rationale for an unconditional capital-funding mechanism is relevant here, the Postal Service does not endorse specific details of the AUC's approach, such as distinguishing between "type 1" and "type 2" capital expenditures, using a capital tracker for certain expenses, or setting the K-bar on the basis of

abandon the problematic conditional approach and adopt a capital-funding model comparable to this K-bar.

The AUC and a number of expert witnesses found an unconditional mechanism to have many advantages that resonate with the Section 3622 objectives and the Commission's findings in Order No. 4258.[228] Echoing the Commission's analysis of the need for more capital spending to increase efficiency, the prospect of "excluding a large portion of a distribution utility's capital additions [via a conditional mechanism] would have the effect of significantly dampening the efficiency incentives intended by [the price cap] plan."[229] By contrast, an unconditional capital-funding mechanism "can generally be assumed to be prudent given the incentives for distribution utilities to deploy capital governed by the [price cap] mechanism in an efficient manner."[230] Indeed, "when the revenue sufficiency condition under [a] pure [price cap] is uncertain," as is the case for the Postal Service even with CPI-based and supplemental rate authority, "the incentives for efficiency are actually stronger" with an unconditional capital funding mechanism, because it "reduc[es] the risk of triggering a reopener due to

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historical investment levels. The latter issue in particular would be inapposite here, where the entire problem is that historical investment levels are far too low.

[228] For additional scholarly support, see Mark E. Meitzen *et al.*, *The Alphabet of PBR in Electric Power: Why X Does Not Tell the Whole Story*, 30 ELECTRICITY J. 30, 36-37 (2017) ("If capital spending cannot be fully accommodated under a comprehensive I−X formula, a second-best solution would be to implement a fixed-price approach to supplemental capital funding that has superior incentive properties to [cost-of-service-regulation]-based capital trackers. . . . In fact, its recent adoption of a fixed-price, capital funding mechanism ('K-bar') moves Alberta closer to a comprehensive approach to [performance-based regulation].").

[229] Decision No. 20414-D01-2016 (errata), 2018-2022 Performance-Based Regulation Plans for Alberta Electric and Gas Distribution Utilities (Alberta Util. Comm'n Feb. 6, 2017), at ¶ 211, http://tiny.cc/AUC-20414-D01-2016.

[230] *Id.* at ¶ 251.

insufficient funding."[231] An unconditional capital funding mechanism also "reduc[es] regulatory burden" and "provid[es] a certain degree of rate stability," compared with a conditional mechanism like a capital tracker or the Commission's proposed performance incentive mechanism.[232] And "[a] K-bar approach maximizes the ability of each distribution utility to manage its business and to discover and pursue efficiencies and costs saving by providing flexibility in how it plans and allocates capital funding throughout the next generation PBR plans while fulfilling its obligation to serve."[233]

From this account, it is clear that an unconditional capital-funding mechanism would serve all of the Section 3622 objectives better than a conditional mechanism, be it a capital tracker or the Commission's proposed PIM. In light of the strong incentive effects of current market pressures, it would lower the odds of revenue insufficiency and a larger-scale reopening of the cap, compared with a conditional mechanism, and therefore provide better efficiency incentives (objective 1). It would be predictable and stable: there would be no question as to whether the Postal Service would have an additional percentage point of rate authority in any given year (objective 2). It would entail less regulatory burden and more transparency than a conditional mechanism (objective 6). It would provide a steady stream of capital to fund needed investments in operational efficiency, service improvement, and mail security, and the restoration of current assets will strengthen the Postal Service's financial stability (objectives 1, 3, 5, and 7). The Commission has linked the size of the proposed pricing authority

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[231] *Id.* at ¶ 212.

[232] *Id.*

[233] *Id.* at ¶ 214.

(1 percent) to quantitative gaps in capital spending, capital assets, and debt replacement, thereby establishing that it is not excessive (objective 8).[234] All of the statutory objectives favor an unconditional capital-funding mechanism.

In providing additional revenues to fund capital spending, an unconditional grant of pricing authority for an initial term would be justifiable and consistent with principles of incentive regulation. If the capital supplement were to strictly follow the AUC's K-bar approach, the additional cap authority would be fixed and not subject to review or reconsideration during the specified term of its operation. Rather, the Commission would use the next Section 3622(d)(3) review to evaluate whether the capital-funding mechanism achieved its purpose of increasing investment in efficiency improvement, and whether that investment bore fruit during the term. An unconditional 1-percentage-point capital-funding mechanism would be consistent with the statutory objectives and the Commission's recognition that the Postal Service needs a capital infusion before it can start the "harmonious cycle."

C. If the Commission Continues to Condition the Capital-Funding Mechanism on TFP Growth, the PIM Requires Various Fixes to Make It Reasonable and Effective

Beyond the fundamental problem of putting the improved-efficiency cart before the capital-spending horse, the mechanics of the proposed PIM set an almost

[234] The Commission has not yet established that it is reasonable, however. While the selection of a 1-percentage-point level is apparently judgmental, the Commission supports it by reference to how quickly it would allow for the restoration of capital outlay levels, net capital assets, and borrowing authority, "[a]ll other things being equal." Order No. 4258 at 54. As the Commission notes, however, all other things – particularly volume trends – are not equal. *Id.* And the computations with which the Commission supports its selection do not appear to account for the elasticity effects of an annual 1-percentage-point increase. The Commission makes no attempt to account for these known factors before settling on a particular proposal. The fact that future volume trends might be uncertain is no reason to make no adjustment whatsoever, given the ample historical data at hand. The alternative approach in Order No. 4258 – acting as if volumes will remain constant – is not justifiable.

impossibly high bar to achievement of the additional rate authority. The problems afflict the Commission's proposed benchmark as well as its proposed method for measuring TFP to compare against that benchmark.

1. The Commission's proposed TFP benchmark level sets an unduly high bar to achievement

There are five problems with the Commission's proposed benchmark. First, it is unclear what degree of precision the Commission intends. In the text of Order No. 4258, the Commission rounds the proposed benchmark figure to three decimal places.[235] In the text of the proposed rule, however, the figure is rounded to a single decimal place.[236] To the extent that the Commission intends the benchmark to be rounded to three decimal places, the rationale for that choice is unclear. However standard three-decimal-place rounding may be when measuring pricing authority, the Postal Service and Commission's historical practice regarding annual TFP growth has been to round to a single decimal place.[237] This is consistent with the Bureau of Labor Statistics' (BLS's) practice in reporting productivity changes.[238] The variables in TFP are not so precise as to warrant measurement of growth rates to three decimal places.[239] In fact, the use of BLS price indices as proxies for Postal Service input prices

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[235] *Id.* at 62, 120 & fn.77 (stating the benchmark as "0.606 percent").

[236] *Id.*, att. A at 24 (proposed Rule 3010.181) (stating the benchmark as "0.6 percent").

[237] *E.g.*, Postal Regulatory Comm'n, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2016 (Mar. 31, 2017), at 16; U.S. Postal Serv., Annual Tables, FY 2017 TFP (Total Factor Productivity) (Feb. 28, 2018), Microsoft Excel file "Table Annual 2017 public (2017 CRA).xlsx", tab "Tfp-52", column K. Even in Order No. 4257, the Commission rounded period-average annual TFP growth rates to two decimal places, not three. Order No. 4257 at 225-26. While that level of precision might be appropriate for a review across two decade-long periods, it would not be appropriate for awarding an incentive based on performance in a specific year or small handful of years.

[238] *E.g.*, Bureau of Labor Statistics, USDL-17-0960, News Release: Multifactor Productivity Trends in Manufacturing – 2015 (July 12, 2017), https://www.bls.gov/news.release/pdf/prod5.pdf.

[239] While the TFP index is reported to three decimal places, a change in the index of 0.001 translates into a growth rate of approximately 0.1 percent.

inheres some approximation error, and TFP can change as a result of BLS revisions up to four months after release of the price indices. TFP also uses Postal Service data that are subject to sampling variability and that employ a variety of econometric and other statistical studies, such as the domestic and international Cost and Revenue Analysis reports.

In this application, the effect of three-decimal-place precision would be unduly severe. Far from accounting for normal variations in TFP data, three-decimal-place precision would punish the Postal Service if measured TFP falls short by as little as 1/10,000 of a percentage point: the difference between, say, 0.6054 percent and 0.6055 percent. That is well within the range of normal variability for even a multi-year TFP average.[240] Such fine gradations may be appropriate when computing the amount of CPI-based pricing authority for products with up to eleven-digit revenues, but not in the context of a binary choice whether or not to award additional rate authority.

Second, the period used to derive the proposed benchmark level does not correspond to any meaningful period. The Commission's use of FY2012-FY2016 in Order No. 4258 is understandable: those were the most recent five years for which TFP data was available as of December 1, 2017.[241] But that happenstance need not control:

[240] For example, the FY2012-FY2016 average annual TFP growth rate has ranged from 0.586 percent to 0.606 percent to 0.614 percent, depending on which vintage of data is used. *Compare* U.S. Postal Serv., Annual Tables, FY 2017 TFP (Total Factor Productivity) (Feb. 28, 2018), Microsoft Excel file "Table Annual 2017 public (2017 CRA).xlsx", tab "Tfp-52", cells K60-K64 (0.614 percent), *with* U.S. Postal Serv., Annual Tables, FY 2016 TFP (Total Factor Productivity) (Mar. 1, 2017), Microsoft Excel file "Table Annual 2016 public (2016 CRA).xls", tab "Tfp-52", cells K60-K64 (0.586 percent), *and* Microsoft Excel file "chir.3.q.2.fy17.tfp.xlsx", tab "Tfp-52", cells K60-K64 (0.606 percent), *filed with* Responses of the United States Postal Service to Questions 1-2, 4-9, 11-13, 15-19, 23, 28, and 31-33 of Chairman's Information Request No. 3, PRC Docket No. ACR2016 (Jan. 13, 2017). Such gremlins are precisely what can be avoided through single-decimal-place rounding and the incorporation of a deadband, as discussed below.

[241] Less understandable is the Commission's apparent use of preliminary TFP tables filed in Docket No. ACR2016, which did not yet incorporate data from year-end FY2016 cost and revenue reports, rather

already, final FY2017 data is available,[242] and there is no reason why the TFP condition for the additional rate authority must begin sooner rather than later. It would be entirely consistent with the "harmonious cycle" rationale for the additional rate authority to be unconditionally available in at least the first years, until sufficient TFP data under the new system – which might reflect the impact of the system's incentives as well as of investments enabled by the additional rate authority – can be measured and accounted for in future rate-authority determinations.

As a matter of principle, FY2012-FY2016 is hardly a meaningful period. Although FY2016 was the last year of the decade that the Commission reviewed in Order No. 4257, it will not have been the last year in which the Postal Service operated under the current system. Depending on the timing of the Commission's final rule, the current system will have persisted through most or all of FY2018. Starting the benchmark period in FY2014 would avoid tainting it with the post-Great Recession surge in TFP growth from FY2010 to FY2013, which is far from representative of the most recent four years' trend.[243] Thus, FY2012-FY2016 is not a rational choice for a benchmark in the final rule.

Third, the proposed benchmark level would also be all but impossible to achieve. Whether it is framed as 0.6 percent, 0.606 percent, or (according to the most recent

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than the final TFP data that the Postal Service filed with the Commission six weeks later (on March 1, 2017). The Commission was clearly aware of the final data when it wrote Order No. 4258. *See* Order No. 4258 at 58 fn.75.

[242] U.S. Postal Serv., Annual Tables, FY 2017 TFP (Total Factor Productivity) (Feb. 28, 2018), Microsoft Excel file "Table Annual 2017 public (2017 CRA).xlsx", tab "Tfp-52".

[243] Even FY2013-FY2017 would at least be consistent with the use of FY2017 or FY2013-FY2017 in setting the supplemental rate authority baseline, as discussed in section IV.A above. Such rigid consistency is not warranted, however, given the specific reasons why FY2013 is inappropriate to include in the benchmark and FY2018 is inappropriate as a measured year.

data) 0.614 percent, the FY2012-FY2016 average annual TFP growth rate is materially higher than the historical average annual growth rate under the current ratemaking system (0.428 percent for FY2008-FY2017).[244] Of course, just to return to those historical-average levels, the Postal Service would have to find substantial new operational-efficiency opportunities that would allow it to overcome headwinds of mail-mix changes and input-price inflation, even though the operational-efficiency measures that remain available to the Postal Service at this point are inherently limited. And then, to meet an approximately 0.6-percent benchmark, the Postal Service would have to beat the even thinner odds of exceeding the historical average every year. None of that is reasonable to expect in the next several years, in light of the constraints discussed in section II.C.2 above. No rational purpose is served by setting a PIM that is unachievable in practice.[245]

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[244] *See* U.S. Postal Serv., Annual Tables, FY 2017 TFP (Total Factor Productivity) (Feb. 28, 2018), Microsoft Excel file "Table Annual 2017 public (2017 CRA).xlsx", tab "Tfp-52", cells K56-K65. The current-system era includes a post-Great-Recession TFP surge that is not likely to be repeatable in the near term: those efficiency steps have already been taken, and if anything, market realities have forced the Postal Service to add work-hours in order to maintain high-quality universal service. *See id.* at 127. But although FY2000 marked a more significant inflection point in the Postal Service's operational-efficiency incentives, USPS March 20 Comments at 123-30, 190-92, including the FY2000-FY2007 would be even less indicative of reasonable forward-looking expectations, because the entire period reflects non-repeatable "breakthrough productivity" efforts as well as the fruits of investment in automation during the 1990s.

[245] Mark Newton Lowry & Tim Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future*, Lawrence Berkeley National Laboratory, Report No. 3 (2016), at 21, http://tiny.cc/Newton-Lowry-Woolf-paper ("Targets should be challenging, but realistically achievable."); Melissa Whited et al., *Utility Performance Incentive Mechanisms: A Handbook for Regulators*, Western Interstate Energy Board (2015), at 35, http://tiny.cc/Whited-et-al-Paper ("The performance target should be realistically achievable by a well-managed utility."); William P. Zarakas & Philip Q Hanser, *Targeted Performance Incentives: Recommendations to the Hawaiian Electric Companies* (2014), at 26-27, http://tiny.cc/Zarakas-Hanser-paper (recommending a target based on a smaller benchmark period more representative of a recent downward trend, in the interest of "mak[ing] the target achievable, but not guaranteeing that the Companies can reach a target level").

Fourth, the proposal uses the specific values of the benchmark and the rolling average as the sole basis for determining whether or not the Postal Service gets additional rate authority. As a result, it would punish the Postal Service if factors beyond its control – such as measurement error, exogenous events, or business-cycle forces – adversely affect the timing or magnitude of TFP gains. To ensure that the performance rewarded by a PIM fairly reflects management's efforts and not exogenous factors, standard regulatory practice is to establish a "deadband" or "neutral zone" around the benchmark.[246] Deadbands "account for uncertainty regarding the optimal performance level, as well as allow for some performance variance based on factors outside of the utility's control."[247] The proposed TFP-linked mechanism does not incorporate this best practice, nor does it offer any other way to address the problem.

Fifth and finally, to the extent that the Postal Service has any influence over the timing of TFP gains, the all-or-nothing benchmark may incentivize it to shift expenses in order to increase the chances of meeting the benchmark in a later year, rather than risking slightly below-benchmark TFP growth across multiple years. These perverse and punitive "cliff effects" are well-documented in the academic literature on which the Commission relies.[248] In regulatory practice, incentives are typically smoothed to offer

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[246] *See* Mark Newton Lowry & Tim Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future*, Lawrence Berkeley National Laboratory, Report No. 3 (2016), at 22; Melissa Whited et al., *Utility Performance Incentive Mechanisms: A Handbook for Regulators*, Western Interstate Energy Board (2015), at 34, 38-39, 57; William P. Zarakas & Philip Q Hanser, *Targeted Performance Incentives: Recommendations to the Hawaiian Electric Companies* (2014), at 12-13, 16-17. In its proposal, the Commission relied on these Newton Lowry and Whited *et al.* papers as authorities on PIM-design principles. Order No. 4258 at 56 fn.74.

[247] Melissa Whited et al., *Utility Performance Incentive Mechanisms: A Handbook for Regulators*, Western Interstate Energy Board (2015), at 38.

[248] Mark Newton Lowry & Tim Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future*, Lawrence Berkeley National Laboratory, Report No. 3 (2016), at 22 ("An additional feature of well-designed [performance incentive mechanisms] is that they avoid 'cliff effects,' or

increasing returns as measured performance approaches the target (or the bottom of any deadband range), as well as, potentially, after it exceeds the target.[249] This approach avoids penalizing the regulated entity for significant but somewhat below-par performance efforts and incentivizes it to outperform the target. Smoothing functions come in linear, quadratic, and step varieties.[250] Although a step function may be the most “common and . . . easy to administer” variant,[251] the lack of any steps beyond “all” and “nothing” leaves the proposed benchmark particularly vulnerable to “cliff effect” drawbacks.[252] As with deadbands, Order No. 4258 does not incorporate regulatory best practice or offer another way to solve this problem.

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substantial changes in earnings due to small changes in performance. Not only do cliff effects create uncertainty regarding utility earnings, but they also introduce significant controversy and contention to the measurement and verification process.”); Melissa Whited et al., *Utility Performance Incentive Mechanisms: A Handbook for Regulators*, Western Interstate Energy Board (2015), at 44 (“Step functions [like the two-step function proposed in Order No. 4258] are common and can be easy to administer, but they have several important drawbacks. When the amount of the penalty or reward can change dramatically with only a small change in performance (e.g., when performance increases from 0.49 standard deviations to 0.5 standard deviations from the target), the performance evaluation process can become very contentious. In addition, such sharp thresholds may induce a utility to engage in unsafe or unsound practices in order to avoid a large penalty or receive a large reward.”).

[249] Smoothing functions can be symmetrical, with penalties below the target as well as rewards above it, or asymmetrical, with only penalties or only rewards. The mechanism proposed in Order No. 4258 does not include penalties, possibly (and appropriately) out of a recognition that, under current circumstances, the new system must provide more, not less, revenue in order to meet objectives 5 and 8. Such a concern is likely not as prevalent in a more typical utility context, where rates are periodically trued-up to ensure a positive rate of return as a matter of course, before the application of a performance incentive mechanism. As a result, the discussion here assumes that the Commission’s focus will remain on rewards, rather than on penalties.

[250] Melissa Whited et al., *Utility Performance Incentive Mechanisms: A Handbook for Regulators*, Western Interstate Energy Board (2015), at 42-45; William P. Zarakas & Philip Q Hanser, *Targeted Performance Incentives: Recommendations to the Hawaiian Electric Companies* (2014), at 20-22, 30-33.

[251] Melissa Whited et al., *Utility Performance Incentive Mechanisms: A Handbook for Regulators*, Western Interstate Energy Board (2015), at 44.

[252] *E.g.*, Order No. 34514, Establishing Performance Incentive Mechanisms and Addressing Outstanding Schedule B Issues, Docket No. 2013-0141 (Haw. Pub. Util. Comm’n Apr. 27, 2017), at ¶¶ 84-85, http://tiny.cc/HPUC-Order-34514 (preferring a linear function to an alternative that “would result in a sudden ‘step function’ jump in incentive levels”).

Without addressing these five issues, the 0.6-percent (or, worse still, 0.606-percent) benchmark proposed in Order No. 4258 would set a nigh-unachievable bar to the additional rate authority, particularly in conjunction with the rolling-average approach to the PIM's TFP-growth metric discussed in the next section. Annual TFP growth failed to cross 0.6 percent in three of the five years within that average (FY2012-FY2016), as it did in FY2017. Indeed, as discussed in the Postal Service's March 20 comments,[253] annual TFP growth has progressively receded since FY2013 and will continue to be challenging in the years ahead; the Postal Service would have to substantially reverse this trend before it could hope to achieve additional rate authority based on a historical TFP benchmark, especially one based not on the most recent period, but on an earlier, higher-TFP-growth period. Such a high bar is entirely unnecessary, in light of the availability of more recent TFP data to use as a pre-new-system benchmark, the established practice of single-decimal-place rounding, and regulatory best practices concerning deadbands and smoothing functions.[254]

2. On the measurement side, the use of a five-year rolling average raises the bar still higher in the early years

Against the five-year historical benchmark, the Commission proposes to compare a five-year rolling average of annual TFP growth. Like the 0.606-percent proposed benchmark, the five-year rolling-average approach would likely have the effect of placing the additional rate authority hopelessly out of reach, particularly in the early years when, according to the Commission's rationale, the additional rate authority is supposed to be getting the Postal Service on the "harmonious cycle." For this reason

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[253] USPS March 20 Comments at 194-96.

[254] Section V.C.3 below will discuss solutions to these problems in greater depth.

as well, the proposed PIM would not succeed in starting the harmonious cycle, nor would it serve as a realistic incentive toward greater operational efficiency.

Before analyzing the Commission's justification, it is necessary to establish a reference point as to how the rolling average would work. Assuming, for the sake of argument, that the benchmark is based on FY2012-FY2016, then the first rolling average compared against that benchmark would be FY2013-FY2017. Four of the five years in the benchmark period and the measured period would overlap; the only differences would be the first year of the benchmark period and the last year of the measured period. Similarly, in the second year, the measured period would be FY2014-FY2018, the first three years of which are the same as the last three years of the benchmark period. And so on. The overlap would not go away until the fifth year, when the FY2017-FY2021 would be compared against the FY2012-FY2016 benchmark.

In the near term, the rolling-average-versus-static-benchmark methodology does not really compare distinct periods; rather, it compares two accumulating averages or sums. If g_{n} represents TFP growth in year *n*, then, in order for the rolling average as of year 6 to meet a benchmark based on years 1-5:

$$\frac{(g_1+g_2+g_3+g_4+g_5)}{5} = \frac{(g_2+g_3+g_4+g_5+g_6)}{5}$$

For this equality to hold, $g_6$would have to equal g_1. By the same token, for the rolling average to meet the benchmark in year 7, $(g_6 + g_7)$ would have to equal $(g_1 + g_2)$. Equivalently, average TFP growth across years 6 and 7 would have to equal that in years 1 and 2. And so on, until year 10 (the fifth year of the new system), when, at last, two distinct five-year periods are compared against one another. Only thereafter does the methodology actually result in a comparison between a rolling five-year average and a static five-year benchmark. Thus, the Commission's proposed FY2012-FY2016 benchmark implies the sequence of thresholds shown in Table 1 below. Because FY2017 TFP growth is now known to have fallen below the threshold in that year, the adjusted effective thresholds for FY2018-FY2021 are also shown. (The FY2017 result would roll out of the average in FY2022.) The effective thresholds considerably exceed the putative 0.614-percent benchmark in the initial years of the mechanism.

Table 1: Threshold TFP-growth amounts needed to meet FY2012-FY2016 benchmark (0.614 percent)[255]

Fiscal year	Annual TFP growth (%)	Five-year average (%)	Threshold to meet benchmark (%)	Nature of threshold	Threshold adjusted for FY2017 (%)	Nature of threshold
2012	0.974	N/A	N/A	N/A	N/A	N/A
2013	1.849	N/A	N/A	N/A	N/A	N/A
2014	0.346	N/A	N/A	N/A	N/A	N/A
2015	0.059	N/A	N/A	N/A	N/A	N/A
2016	-0.159	**0.614**	N/A	N/A	N/A	N/A
2017	-0.627	0.294	0.974	Single year	N/A	N/A
2018	TBD	TBD	1.412	2-year av.	3.451	Single year
2019	TBD	TBD	1.056	3-year av.	1.899	2-year av.
2020	TBD	TBD	0.807	4-year av.	1.285	3-year av.
2021	TBD	TBD	0.614	5-year av.	0.924	4-year av.
2022	TBD	TBD	0.614	5-year av.	0.614	5-year av.

There does not appear to be a justification for this particular sequence of TFP growth figures as the required thresholds in the first four years of the new-system period.

Indeed, the sequence is exactly the opposite of what the "harmonious cycle" logic would suggest. The "harmonious cycle" concept correctly identifies the problem that operational efficiency will lag at the beginning of the new system, due to inadequate capital investment levels, and posits that operational efficiency may rise during the period as a result of capital investments in the early years. But the Commission's proposal would create a sequence of accumulating-average TFP growth thresholds that starts significantly above the putative benchmark (due to the Postal Service's post-Great-Recession TFP surge five years ago) and then eases back in the later years (due to the implementation of those TFP-improving measures, changes in the mail mix, and other factors that have caused TFP to decline since FY2013). That sequence of thresholds would withhold access to the "harmonious cycle" precisely in the early years when it is most needed, and precisely when the Postal Service is least likely to meet such demanding thresholds. To make matters worse, the rolling average would carry over any shortfall in the first years into commensurately higher thresholds in later years, and the start of the "harmonious cycle" would recede into the horizon.

While section V.C.1 above explains why a FY2012-FY2016 benchmark would be almost certainly unachievable at any time in the foreseeable future, Table 1 demonstrates how especially unachievable it would be in the early years. The putative threshold for additional rate authority in FY2019 would require two-year average TFP growth of 1.412 percent. That is already a high bar: two-year average TFP growth only reached that level twice in the current-system era (FY2010-FY2011 and FY2012-FY2013, the same period as the putative threshold), in both instances reflecting, to some extent, a TFP catch-up in the recovery from the Great Recession. When the known below-threshold result in FY2017 is taken into account, TFP growth would have to be a nearly unprecedented 3.451 percent in FY2018 to compensate for the FY2017 shortfall. Single-year TFP growth has not been that strong in twenty-five years (since FY1993), and that growth was exceeded only once (FY1973). The adjusted two-year average growth rate required in FY2019 would also be unprecedented in the current-system era, with only five earlier years meeting that level. The three-year average growth rate required in FY2020 would similarly be unusually high for the current-system era.

Updating the benchmark to, say, FY2013-FY2017 would not appreciably change the methodology's flawed structure.[256] Although the benchmark would putatively be 0.3 percent (if rounded; 0.294 percent otherwise), that lower-seeming level will only be operative in FY2022 and beyond; until then, what matters is the pattern of accumulating averages. The Postal Service would still face a tremendous challenge in FY2018's first-year threshold level of 1.849 percent, as there is no reasonable expectation that FY2018 TFP growth will cross that threshold. Annual TFP growth reached that level only twice in the current-system era (FY2010 and FY2013, the effective threshold year for FY2018).[257] That threshold is more than four times the average annual TFP growth rate since the current ratemaking system began in FY2008 (0.428 percent). Nor would the additional rate authority be any more achievable in FY2019, when the Postal Service will have to have achieved an average FY2018-FY2019 TFP growth of at least the FY2013-FY2014 average (1.098 percent). That is still more than double the average two-year TFP growth rate during the current-system period (0.539 percent). And if TFP (despite all headwinds) grew at the historical current-system-era rate in FY2018, TFP would have to grow at least 1.768 percent in FY2019 to compensate for the FY2018 shortfall: a single-year growth rate, like the FY2018 threshold, matched in

[256] As discussed in the previous section, one decimal place would be more appropriate to use in an actual benchmarking exercise. Three decimal places are used here strictly for illustrative purposes.

[257] U.S. Postal Serv., Annual Tables, FY 2017 TFP (Total Factor Productivity) (Feb. 28, 2018), Microsoft Excel file "Table Annual 2017 public (2017 CRA).xlsx", tab "Tfp-52", cells K58 & K61.

only two other current-system-era years, and more than four times the current-system-era average annual growth rate.

As the following table shows, even if the benchmark were lowered to 0.294 percent, the declining-TFP-growth trend were reversed, and annual growth somehow returned to the current-system-era average, the Postal Service would still fall short of attaining the TFP-based rate authority in any of the first four years.

Table 2: Simulation of new-system-era TFP benchmarking with FY2013-FY2017 benchmark (0.294 percent) and historical-average TFP growth assumed in FY2018-FY2022

Fiscal year	Annual TFP growth (%)	Five-year average (%)	Benchmark achieved?
2013	1.849	N/A	N/A
2014	0.346	N/A	N/A
2015	0.059	N/A	N/A
2016	-0.159	N/A	N/A
2017	-0.627	**0.294**	N/A
2018	0.428	0.009	**N**
2019	0.428	0.026	**N**
2020	0.428	0.100	**N**
2021	0.428	0.217	**N**
2022	0.428	0.428	**Y**

Note that rounding to a single decimal place would not change the result: FY2022 would still be the first year to meet the 0.3-percent benchmark.[258]

It must be emphasized that the use of historical-average TFP growth rates in Table 2 is strictly illustrative. In reality, there is no indication that the Postal Service will be able to return to such TFP growth rates in the near term. Record evidence in this proceeding indicates approximately $3.9 billion in total cost savings under management

[258] Updating the benchmark to FY2014-FY2018 might go farther toward making the benchmark achievable, as FY2013's unusually strong -- and, in terms of near-term expectations, non-representative – post-Great-Recession TFP growth would no longer be included in the benchmark.

control over the next five years.[259] That figure cannot be translated directly into a TFP-growth forecast, as TFP is influenced by a variety of other factors. Yet even without discounting for those likely countervailing factors, it bears noting that the historical-average TFP growth rate would imply annual incremental savings of $0.3 billion (= 0.428 * $0.7 billion), which would compound to approximately $4.5 billion in total savings over five years. Thus, even if all other aspects of TFP were held constant – an ideal assumption, not a realistic one – the cost savings opportunities supported on the record here would still render the proposed TFP-based rate authority even more remote than Table 2 suggests.

This analysis makes clear that the proposed TFP-based rate authority is all but unachievable in the near term, and that the Postal Service cannot simply "overcome the challenges to finding new ways to increase efficiency."[260] By using an accumulating-then-rolling-average methodology without consideration of what levels of TFP growth can realistically be achieved in the coming years, the proposed PIM places the additional rate authority virtually out of reach. Given the limited cost-savings opportunities identified on the record and the other headwinds that make even historical-average TFP growth rates unlikely in the near term,[261] the Commission would do well to forgo imposing a TFP-growth condition on additional rate authority until at least the next Section 3622(d)(3) review, when it can re-assess whether TFP growth trends and potential at that time might make such a condition realistic as an incentive.

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[259] USPS March 20 Comments, appx. C at 4-5.

[260] Order No. 4258 at 61.

[261] *See* section II.C.2 *supra*.

3. The rolling-average approach is based on faulty premises

Not only is the rolling-average approach counterproductive in terms of financial stability and operational-efficiency incentives, it is based on faulty logic. The Commission bases its use of a rolling average on four premises:

> [(1)] Use of a rolling 5-year average for TFP growth should allow enough time for the effects of any long-term investments to appear in the TFP calculation.
>
> [(2)] This also minimizes the possibility raised by both the Postal Service and Christensen of an isolated annual result being unrepresentative.
>
> [(3)] Moreover, this approach is consistent with the Commission's maximization analysis in Order No. 4257, which compared the pace of efficiency gains by comparing the 10 years of experience in the PAEA era and the 10 years immediately preceding implementation of the PAEA. *See* Order No. 4257 at 248.
>
> [(4)] This approach, therefore, should incentivize the Postal Service to achieve efficiency gains sufficient to contribute to the financial stability of the Postal Service.[262]

None of these premises holds up to serious examination.

It is unclear what "long-term investments" are intended in the first premise, and it is even less clear how they would be accommodated by the rolling average. As explained in the previous section, each new rolling average includes a number of years that predated the new system. TFP results in those past years do not reflect current investments at all, much less future investments that might be funded by the proposed PIM's additional rate authority. All that those past results reflect are the effects of investments made still farther in the past. It is hard to see what value such a backward-looking metric has in an exercise ostensibly aimed at measuring and incentivizing efficiency growth in the future.

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[262] Order No. 4258 at 62.

On the other hand, the Commission's reference to "enough time" may mean that the five-year rolling average would somehow allow the effects of current investments to show up in the measured period in the later years. That may be true, but it does not justify the use of a rolling average in the near term, before the effects of new investment are likely to manifest in annual TFP growth rates, and when recent TFP growth is depressed, in part, by the cumulative effects of low capital-investment levels. Other approaches, such as a cumulative average, would achieve the same result in the later years, without the rolling average's near-term problems. Nor does it explain how "the effects of any long-term investments [can] appear in the TFP calculation" if no additional capital is provided to begin the "harmonious cycle" and create TFP effects in the first place. If anything, this premise supports the adoption of an unconditional, interim capital-funding mechanism, at least until such time that the Commission can measure the effects of investments facilitated by the additional revenue.

Yet another interpretation of the first premise is that the five-year rolling average "may better encourage the [Postal Service] to adopt sound long-term practices," rather than focusing on "short-run solutions" that "may only have short-term benefits."[263] If that is the Commission's goal, then it is hard to square with the Commission's apparent lack of concern that an all-or-nothing benchmark could similarly "induce [the Postal Service] to engage in unsafe or unsound practices in order to avoid a large penalty or receive a large reward."[264] More to the point, whatever merit a rolling-average PIM might have in

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[263] *See* Melissa Whited et al., *Utility Performance Incentive Mechanisms: A Handbook for Regulators*, Western Interstate Energy Board (2015), at 39, http://tiny.cc/Whited-et-al-Paper.

[264] *See id.* at 44.

contexts like service reliability or employee safety,[265] it makes little sense for TFP, where the Postal Service's cost-reduction incentives have long been clear. And unlike the typical utility that enters a price-control period from a point of financial stability, the Commission's very justification for the PIM is predicated on years of inadequate capital investment. This means that, to the extent that rolling-average TFP growth measures any long-term investment effects, those effects will continue to reflect historic underinvestment for years to come.

The second premise takes the Postal Service and Christensen's remark out of context. That remark concerned the need to review past TFP performance over the course of multiple years, rather than in terms of a single, possibly unrepresentative single year.[266] It did not contemplate the use of TFP in a forward-looking PIM – nor could it have, as such a concept was not foreshadowed in Order No. 3673, the Postal Service's comments, or, indeed, any source prior to Order No. 4258.

Third, the rolling-average approach has little in common with Order No. 4257's "maximization analysis." That analysis compared multi-year trends across two consecutive periods: FY1997-FY2006 and FY2007-FY2016.[267] As explained in the previous section, the proposed PIM would feature such a comparison only in the new system's fifth year. For the first four years of the new system, the rolling-average approach would compare two non-consecutive, overlapping periods, such as FY2012-FY2016 and FY2013-FY2017; put another way, it would compare single-year growth

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[265] These contexts are the only examples of rolling-average-based reward mechanisms cited or hypothesized by Whited *et al.* *Id.* at 77, 103, 104-105.

[266] *See* Order No. 4258 at 59, 62 (citing USPS March 20 Comments at 57, 197 & appx. D at 6).

[267] Order No. 4257 at 222-26.

rates as of year 1, followed, in years 2 through 4, by comparisons between non-consecutive accumulating averages. In year 6 and beyond, the comparison would be between non-consecutive five-year averages.

Fourth and finally, as discussed in the previous section, the rolling-average approach, in combination with a static benchmark, places the additional rate authority too far out of reach to serve as an effective incentive.

In short, there is no rational justification for the Commission's proposed accumulating-then-rolling-average approach. A backward-looking rolling average is not necessary to pick up the long-term effects of near-term investments, and it would inexplicably saddle near-term measurements with the effects of inadequate past investment levels. The use of multi-year averages for retrospective review purposes does not necessitate a commensurate multi-year approach in a forward-looking incentive. The accumulating-then-rolling-average approach is not consistent with the Commission's own "maximization analysis" in Order No. 4257. And most importantly, the rolling average sets too high a bar to be an effective incentive or to provide any contribution toward financial stability.

4. If the Commission retains a conditional PIM, it should revise the proposal to address these problems

The discussion thus far has identified six problems with the proposed TFP-based rate authority. Most fundamentally:

(1) The "productivity-results-then-authority" approach runs counter to the Commission's rationale of providing additional capital up front, in order to start the "harmonious cycle" and improve productivity.

In addition to this key conceptual problem, five other, more technical problems must be addressed:

(2) The proposed FY2012-FY2016 benchmark is out of date, sets an almost impossibly high bar, and would base eligibility for additional rate authority on TFP growth before the new system;

(3) The five-year rolling average would effectively lock in an arbitrary series of cumulative TFP-growth thresholds that start well above the putative benchmark rate and would be nigh-unachievable in the early years;

(4) By fixing eligibility for the additional rate authority exactly on the historical-average-TFP benchmark, the proposed mechanism incorporates no margin for statistical noise, measurement error, and business-cycle influences, contrary to regulatory best practices of PIM design;

(5) Also contrary to best practices of PIM design, the proposed mechanism's all-or-nothing nature would punish the Postal Service for positive but below-benchmark productivity gains; and

(6) Three-decimal-place precision would be unduly strict and contrary to historical practice.

Each of these problems is solvable. The most basic solution would be to make the capital-funding mechanism unconditional, as discussed in section V.B above: by solving the first problem without reservation, it would render the others moot. Even within a conditional, TFP-benchmarking paradigm, however, it would only take a few revisions to the proposed rule to solve the problems identified above. While the fixes bear some explanation, they would actually be simple and transparent to implement. The next three sections explain each fix in detail, followed by a fourth section that unifies them into a coherent framework.

a. <u>Getting on the "harmonious cycle" and updating the benchmark period</u>

The most effective way to conform the performance-based authority to the Commission's "harmonious cycle" rationale would be to make the authority unconditional in all years until the next Section 3622(d)(3) review, as discussed in section V.B.3 above. As explained in that section, there is regulatory precedent for such an unconditional capital-investment funding stream. At a minimum, however, the rationale dictates that the Postal Service must be given a measure of "seed money" up front, in order to start funding a higher level of efficiency and service improvements. Thus, the 0.75-percentage-point rate authority should be made available without preconditions in at least the first year or two, until new-system-era TFP data is available per the updated benchmark discussed below. The Commission should also consider whether the rate authority should be made unconditionally available in additional years, in terms of whether its chosen benchmark will be realistically achievable in the first years of the comparative exercise.

To solve the problems with the benchmark, the Commission should update the benchmark period.[268] The current system will have remained in place through most or all of FY2018; because it does not indicate performance in response to the new system, it is not a valid candidate for a measured period. And compared with FY2012-FY2016 or even FY2013-FY2017, the FY2014-FY2018 period better reflects the headwinds and level of remaining TFP-improvement opportunities available to the Postal Service going into the new system.

The first two solutions work hand-in-hand to allow the additional rate authority – and its "harmonious-cycle"-inducing effects – to start sooner rather than later. If FY2014-FY2018 is the new benchmark period, as it should be, then the first measured year's data will not be available until final FY2019 TFP statistics are released in March

[268] The Commission would also be justified in doing away with a historical benchmark altogether and recognizing that, in the near term, any annual TFP gains above 0 percent are worth celebrating, given the limited potential for further gains after years of strenuous effort and under-investment. *See* USPS March 20 Comments at 145-47 & appx. C at 4-5. This would also be supported by computation of a "deadband" consistent with regulatory practice, as discussed in section V.C.4.c below.

2020. The earliest that that data could translate into additional authority would be calendar year 2021. It would be consistent with the “harmonious cycle” concept to provide the performance-based authority sooner than that; given the lack of post-benchmark TFP data, the performance-based authority would have to be unconditional in the first two years (2019 and 2020). Order Nos. 4257 and 4258 identified the capital-spending gap as a problem as of FY2016; it would be gratuitous and arbitrary to wait until 2021 to begin solving that problem, rather than starting in 2019.[269]

b. Replacing the rolling-average approach

With the first measured year being updated to reflect new-system-era performance and the performance-based authority made unconditionally available in the meantime, the next problem to solve would be the problems created by the Commission’s proposal to compare a rolling average with static benchmark. Such an exercise makes sense only if what is being measured against that benchmark is performance under the new system, theoretically in response to the new system’s incentives and the factors that affect the Postal Service’s ability to achieve TFP growth in the current environment, rather than performance during the same old-system years used in the benchmark. In theory, a backward-looking rolling average would not do that in the initial years. The period to be measured against the five-year average benchmark should be restricted to new-system years.

[269] *See* section VI.B.2 *infra*. Even if the Commission used FY2013-FY2017 as the benchmark period, conditional rate authority could not become available until 2020, the first year after final FY2018 TFP data is filed in March 2019. This would warrant making the rate authority available unconditionally in 2019, as well as potentially in 2020 and even 2021, given the hurdles to achievement in those years identified in section V.C.2.

As explained in section V.C.2 above, the Commission's proposed approach can be seen in a different light. In the near term, the overlapping five-year-average periods used on both sides of the equation convert the exercise into a comparison of two sets of accumulating averages that start five years apart. Put this way, the problem is not with the measured period, which (if the benchmark were updated according to the previous section) would appropriately capture only new-period TFP growth. Rather, the problem is that those accumulating averages are compared not against the putative five-year-average benchmark, but against an arbitrary series of corresponding accumulating averages starting with the early part of the benchmark period, when TFP growth rates were highest. The historical standard to which early new-system years' performance would be held does not reflect any meaningful expectations about the new period, and it sets too high a bar to achievement of the additional rate authority that is supposed to start the "harmonious cycle."

The solution to this problem starts by abandoning the rolling-average-versus-benchmark framework, which does not accurately represent the exercise in the near term anyway. Instead, the Commission should explicitly compare new-system-era accumulating averages against the five-year-average benchmark.[270] To return to an illustrative example from section V.C.2, if the benchmark were updated to the FY2013-FY2017 average, then FY2018 TFP growth would have to be at least 0.294 percent, rather than 1.849 percent. The next year, FY2018-FY2019 average TFP growth would

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[270] It is important to note that the purpose of this approach, which would be based on a single year or a small number of years at first, is to award incentives in an effort to prospectively raise the longer-term TFP-growth trend rate. As such, it does not conflict with record evidence about the need to review past TFP performance over the course of multiple years, rather than in terms of a single, possibly unrepresentative single year. *See* Order No. 4258 at 59, 62 (citing USPS March 20 Comments at 57, 197 & appx. D at 6).

likewise have to be at least 0.294 percent, rather than 1.098 percent. And so on. This approach would still reward the Postal Service for above-benchmark TFP growth in the early years. But it would avoid punishing the Postal Service for failing to meet a specific threshold that is far above the putative benchmark. There is no principled reason why the Postal Service should only be rewarded for first-year TFP growth of, say, 1.849 percentage points simply because that happened to be the rate five years earlier, and not for similarly above-benchmark-average growth of, say, 0.849 percent. Using the whole-period benchmark would thereby remain agnostic as to the particular sequence of new-system years' TFP growth rates, so long as the average meets or exceeds the benchmark.

Early-year achievability would provide more robust incentives to the Postal Service. Not only would the Postal Service qualify for the additional rate authority in those years, it could also "bank" the excess TFP growth toward later years with below-benchmark TFP growth, allowing the Postal Service to continue qualifying for additional rate authority so long as the cumulative average does not dip below the benchmark level.

But there is a separate concern with the use of an accumulating measured-period average, which leads to the need for a second fix for the eligibility analysis. As explained in section V.C.2 above, the use of a multi-year average means that below-threshold TFP growth in the first year raises the threshold still further in later years. Even if the threshold is lowered through the use of a static benchmark, the effect remains possible. If benchmark-level TFP growth remains challenging in the early years – as all indications suggest – then a strictly accumulating-average measurement approach would still withhold the additional rate authority until after the Postal Service can compensate for the early shortfalls. The Postal Service would remain forever saddled with the effects of bad early years, and the PIM might not be either fair or effective as an incentive mechanism.

To illustrate this problem, consider a scenario (“Scenario 1”) with an initial year of below-benchmark TFP growth, followed by a number of years of annual TFP gains at or above the benchmark. In that situation, the subpar first year might drag down future years’ averages and render the TFP-based authority unachievable for years thereafter, notwithstanding commendable achievement in the majority of the years. The punitive result is clear in contrast to a second situation (“Scenario 1”) with identical TFP achievement in the later years but benchmark-level growth in the first year. The table below illustrates this problem, again assuming a hypothetical 0.3-percent benchmark.

Table 3: Comparison of TFP growth scenarios under accumulating-average-only approach (benchmark = 0.3 percent)

	Year 1	Year 2	Year 3	Year 4
Scenario 1				
Annual growth rate	0.1%	0.3%	0.3%	0.5%
Cumulative average growth rate	0.1%	0.2%	0.23%	0.3%
Additional authority?	**N**	**N**	**N**	**Y**
Scenario 2				
Annual growth rate	0.3%	0.3%	0.3%	0.3%
Cumulative average growth rate	0.3%	0.3%	0.3%	0.3%
Additional authority?	**Y**	**Y**	**Y**	**Y**

The average annual TFP growth rate is approximately the same in both scenarios here. But the accumulating-average approach would penalize the Postal Service for how the growth is distributed across the period. In Scenario 1, the underperformance in year 1 would deprive the Postal Service of TFP-based authority not only in that year, but also in years 2 and 3, even though the Postal Service met the benchmark in those years just as in Scenario 2. Thus, the cumulative-average approach presents a fairness problem.

The solution is to couple the accumulating-average approach with an alternative condition, allowing the additional rate authority to be awarded if, notwithstanding a lagging accumulating average, the relevant single year's TFP growth is above the benchmark. In Table 3 above, the Postal Service would then receive the additional authority in years 2 and 3 of Scenario 1; the negative impact of year 1's subpar TFP growth would be limited to the non-attainment of additional rate authority in that year. The single-year alternative would preserve the TFP-based authority's incentive value by limiting the impact of a single bad year and allowing the Postal Service to focus on keeping annual TFP growth above the benchmark level. After all, a single bad year may reflect exogenous factors outside the Postal Service's control or the near-term impact of capital spending decisions, and it would be unfair to make the achievability of the next year's rate authority subject to such vagaries in an earlier year.

The Postal Service does not propose to apply a single-year measurement approach on its own: doing so would have its own shortcomings. The Postal Service does not have full or precise control over the timing of TFP gains, and the single-year approach would deny it credit in some years if TFP gains are uneven rather than smoothly distributed. To the extent that the Postal Service can control the timing of TFP growth, it might have less incentive to aim for substantially above-benchmark TFP growth in a given year, and more incentive to delay initiatives in the interest of meeting the benchmark in future years to ensure the availability of needed rate authority. The following table illustrates this with two scenarios of equivalent (simple) average annual

TFP growth rates, but with differing distributions of growth across the individual years. In both scenarios, the benchmark is assumed, hypothetically, to be 0.3 percent.

Table 4: Comparison of TFP growth scenarios under single-year-only approach (benchmark = 0.3 percent)

	Year 0	Year 1	Year 2	Average (years 1-2)
Scenario 3				
TFP index	100	100.8	101.0016	**100.9008**
Annual growth rate	--	0.8%	0.2%	0.5%
Additional authority?	--	**Y**	**N**	--
Scenario 4				
TFP index	100	100.5	101.0025	**100.7513**
Annual growth rate	--	0.5%	0.5%	0.5%
Additional authority?	--	**Y**	**Y**	--

In both scenarios, the average annual TFP growth rate is the same, and the TFP index has reached virtually the same level in Year 2. But the average annual TFP index across the two years is almost 0.15 higher in Scenario 3 than in Scenario 4. Thus, Scenario 3 features greater efficiency and cost-reduction across the entire period, due to its stronger growth in year 1, yet the single-year-only approach would award more years of additional rate authority in (lower-efficiency) Scenario 4. Only if the accumulating-average approach is used as an alternative would the Postal Service receive the TFP-based authority in both years of (higher-efficiency) Scenario 3, as well as in both years of Scenario 4. Thus, the Postal Service would no longer have a disincentive to achieve substantially above-benchmark single-year gains; to the contrary, such gains could help to insure against shortfalls in future years' TFP growth, and the Postal Service would, of course, benefit from the greater level of cost reduction in Scenario 3.

The shortcomings of each approach can be addressed, and their benefits retained, by combining the two into an "either/or" formulation. Thus, the 0.75-

percentage-point additional authority would be awarded **if either TFP growth in the measured year or average annual post-benchmark-period TFP growth as of that year is at least equal to the benchmark growth rate**. This would avoid punishing the Postal Service for the distribution of annual TFP growth, over which it has limited control, and setting perverse incentives to achieve only the benchmark and little more. In Table 4, the use of an accumulating-average condition would fully reward, rather than punish, the Postal Service for its front-loaded TFP growth in Scenario 3. By allowing overachievement to be banked as insurance against future years, the cumulative-average condition would not disincentivize the Postal Service to aim high, especially in the early years, when the cumulative benefits over time would be greater. Meanwhile, the inclusion of an alternative single-year condition would serve as a backstop against a bad year's unduly punitive legacy effects: in Scenario 1 of Table 3, for example, the Postal Service would lose the TFP-based authority in the year of its underachievement (year 1), but it would now be rewarded for achieving benchmark-level TFP growth in Years 2 and 3.[271] In addition to promoting fairness and maximizing incentives to match or exceed the benchmark period's average annual TFP growth, this "either/or" approach would avoid the arbitrariness problems of a rolling average and appropriately tailor the mechanism's incentives to performance during the new system.

c. Rounding, ranging, and smoothing to adjust for noise and cliff effects

Even with the remedy in the preceding section, the Commission's proposal to use an all-or-nothing approach to awarding the TFP-linked rate authority unreasonably

[271] The "either/or" formulation would not change the fact that the Postal Service would receive the TFP-based authority in all years in a scenario of steadily above-benchmark growth, such as Scenarios 2 and 4 on the tables above.

punishes the Postal Service for below-benchmark gains that might nevertheless reflect aggressive management. It might also punish the Postal Service if factors beyond its control affect the timing of planned TFP gains. To the extent that the Postal Service has any influence over the timing of such gains, its incentive might lie in deferring initiatives in order to increase the chances of meeting the benchmark in a later year, so as to ensure necessary pricing authority, rather than risking slightly below-benchmark TFP growth across multiple years. The Commission's potential specification of the benchmark to three decimal places only makes matters worse, as it would hinge 100 percent of the TFP-based authority on as little as 0.0001 percentage points of TFP growth. The all-or-nothing approach would lead to the sort of unnecessarily risky "cliff effects" that regulators strive to avoid.

Regulatory best practice suggests two remedies.[272] The first is a modified application of a deadband. As discussed in section V.C.1 above, deadbands are intended to account for variability in the performance metric due to factors outside the regulated entity's control. This ensures that the performance rewarded by the mechanism can fairly be attributed to management's efforts and not exogenous factors.

> Deadbands can be set based on percentages, *e.g.*, the deadband surrounding [San Diego Gas and Electric]'s customer service targets is +/-1%. However, they are more frequently set on a statistical basis involving standard deviations, a widely used and well accepted statistical measure which indicates the range and variability of a series of observations. A

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[272] William P. Zarakas & Philip Q Hanser, *Targeted Performance Incentives: Recommendations to the Hawaiian Electric Companies* (2014), at 12-13, http://tiny.cc/Zarakas-Hanser-paper (attesting to the universality of deadbands and smoothing functions among foreign regulators and those in California, Massachusetts, and New York). In proceeding for which Zarakas and Hanser prepared their report on behalf of electrical utilities, both the utilities and the Consumer Advocate proposed PIMs with deadbands and smoothing functions, and the Hawaii Public Utilities Commission followed suit and adopted such mechanisms. Order No. 34514, Establishing Performance Incentive Mechanisms and Addressing Outstanding Schedule B Issues, Docket No. 2013-0141 (Haw. Pub. Util. Comm'n Apr. 27, 2017), at ¶¶ 20-34, 80-86, 91, http://tiny.cc/HPUC-Order-34514.

> deadband equal to +/- one standard deviation should account for roughly 68% of random events that affect utility performance. Performance that falls outside of +/- one standard deviation can then be attributed to non-random events; that is, actions that were under the utility's control. Deadbands defined in terms of standard deviations are used in several [targeted performance incentive] plans, *e.g.*, by the Massachusetts [Department of Public Utilities] in the performance incentive plan applied to National Grid.[273]

Consistent with the recommended practice, the Commission could therefore justify awarding the Postal Service the additional authority if measured TFP growth[274] meets or exceeds the benchmark minus one standard deviation. On its face, this would not be a traditional application of a deadband as a "neutral zone" between penalties and rewards on either side. But the rationale underlying the proposed performance incentive mechanism – that the Postal Service needs an additional 1 percentage point of pricing authority per year in order to close the capital-spending gap – translates into a baseline expectation of an additional 0.75 percentage points per year, not 0 percentage points per year. Any additional authority less than that baseline is effectively a penalty, in terms of slowing the pace of capital-asset replenishment. And the logic underlying the deadband concept supports treating results within a one-standard-deviation range as potentially indicative of benchmark-level management performance.

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[273] William P. Zarakas & Philip Q Hanser, *Targeted Performance Incentives: Recommendations to the Hawaiian Electric Companies* (2014), at 16-17 (footnotes omitted). *See* Mark Newton Lowry & Tim Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future*, Lawrence Berkeley National Laboratory, Report No. 3 (2016), at 22, http://tiny.cc/Newton-Lowry-Woolf-paper ("Deadbands are frequently set at one standard deviation of historical performance, but may be larger or smaller based on sample size and the tolerance for error. That is, if a large amount of historical data is available, then one standard deviation is likely to capture most of the normal variation in a metric."). *See also* Order No. 34514, Establishing Performance Incentive Mechanisms and Addressing Outstanding Schedule B Issues, Docket No. 2013-0141 (Haw. Pub. Util. Comm'n Apr. 27, 2017), at ¶¶ 80-86, 91 (adopting a deadband set at with +/- one standard deviation, as recommended by utilities and the Consumer Advocate alike).

[274] Consistent with the previous section, "measured TFP growth" can mean either single-year or cumulative-average TFP growth, whichever is greater.

There are multiple justifiable ways in which the Commission could calculate a one-standard-deviation range on the basis of historical data.[275] Thirty-five years' worth of annual TFP-growth data (from FY1971 to FY2017) yields a standard deviation of 1.5 percentage points. The standard deviation for the current-system era (from FY2008 to FY2017) is 1.0 percentage point.[276] One standard deviation of 5-year rolling averages of annual TFP growth rates since FY1971 is approximately 0.6 percentage points.

It may be that the lower bound of the range would grant TFP-based authority with putatively negative measured TFP growth. For example, a 0.6-percentage-point range around a 0.3-percentage-point target would grant the authority for measured TFP growth of -0.3 percentage points. As a matter of principle, that should not pose a problem. Rather, it would merely account for the influence on annual (and even multi-year average) TFP results of exogenous forces, year-to-year variation in the timing of cost and workload changes, and other statistical noise. If those factors could be adjusted out, a putative result of -0.3 percentage points might well be consistent with management achievement that otherwise would have yielded (positive) 0.3-percentage-point TFP growth. That is the very point of the standard-deviation-based deadband.[277]

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[275] The figures in this paragraph were derived from U.S. Postal Serv., Annual Tables, FY 2017 TFP (Total Factor Productivity) (Feb. 28, 2018), Microsoft Excel file "Table Annual 2017 public (2017 CRA).xlsx", tab "Tfp-52", column K.

[276] *See* William P. Zarakas & Philip Q Hanser, *Targeted Performance Incentives: Recommendations to the Hawaiian Electric Companies* (2014), at 28 (recommending a deadband based on ten years of data, notwithstanding the recommendation of a five-year-average benchmark, because "a stable standard deviation (and one that is usable for purposes of inclusion as a deadband) requires more than three observations, and five observations is acceptable but only barely so").

[277] If, however, the Commission would prefer to avoid awarding TFP-based pricing authority for nominally negative measured TFP growth, it could set the floor at 0-percent measured TFP growth. This would also recognize that, notwithstanding growth trend rates in the pre- or earlier-post-PAEA periods, annual TFP growth rates have recently been trending negative, and <u>any</u> sustained positive TFP growth will be challenging enough in the coming years.

No matter what, the Commission should clarify that the benchmark and measured results are to be rounded to a single decimal place, as stated in the proposed rules. This rounding would establish a +/- 0.05-percentage-point range around the benchmark. At less than one-tenth of one standard deviation, that range would be far narrower than the range that regulators typically use for a deadband. But it is something that should be done in any case. As described in section V.C.1 above, the variables in TFP and management's control over costs are not so precise as to warrant the degree of exactitude implied by expressing TFP growth rates to three digits.

Even with a deadband, and especially with the narrow quasi-deadband that would result from single-decimal-place rounding, a significant cliff effect would remain. This would call for the second possible solution. As discussed in section V.C.1 above, regulators typically use smoothing functions to offer increasing financial incentives as measured performance approaches or exceeds the target (or deadband). A more gradual smoothing function would avoid the drawbacks of the Commission's two-step function. Such a better-designed reward system would link incremental productivity gains to incremental increases in the price cap. A smoothed mechanism might mitigate incentives for the Postal Service to try to strategically time TFP-growing initiatives. Since, all other things being equal, high rates of TFP growth would imply cost savings that would reduce the need for additional revenue, a smoothing function could also allow the additional cap authority to be gradually reduced at high levels of TFP growth.

A linear function can be expressed as a formula, but, with single-decimal-place rounding and a relatively limited range, it essentially translates into a series of steps between "all" and "nothing." Put another way, a step function with more than two steps would more closely approximate a linear function and go part of the way toward mitigating harmful cliff effects. The following table illustrates one example of a simple, transparent tiered structure, based on a hypothetical target of 0.3 percent.[278]

Table 5: Example of hypothetical linear/multi-step framework

If either single-year or cumulative-average TFP growth is:	Then the TFP-based authority is:
0.0% (or less)	0.00%
0.1%	0.25%
0.2%	0.50%
0.3% (or more)	0.75%

In other words, for each tenth of a percentage point of positive annual TFP growth up to the assumed 0.3-percent target, the Postal Service would get one-third of the 0.75 percentage point of additional authority. This basic model is amenable to whatever modifications the Commission finds necessary to supply what it considers to be meaningful incentives. If the Commission wished to use a linear, quadratic, or multi-step function to smooth incentives more evenly across the range, then it might be warranted to use a greater number of decimal places.[279] If the Commission wanted to add stronger incentives for above-benchmark growth, it could simply add tiers to the desired maximum level.[280] If the Commission would prefer to incentivize a greater

[278] The table could also be expressed formulaically as $A = 2.5\ \%\Delta TFP$, where A is TFP-based rate authority, $0.0 \geq \%\Delta TFP \geq 0.3$, and $\%\Delta TFP$ is rounded to a single decimal place.

[279] For example, rounding TFP growth to two decimal places would expand the range of rate-authority increments between $0.00 \geq \%\Delta TFP \geq 0.30$ from four 0.25-percent increments to thirty-one 0.025-percent rate-authority increments. It must be emphasized that, as discussed in section V.C.1 above, such greater precision would is only warranted with a smoothing function; it would heighten, not lessen, cliff effects in conjunction with the small number of steps proposed in Order No. 4258 or shown in Table 5 above.

[280] For example, the same formula as in the previous footnote could be extended to $0 \geq \%\Delta TFP \geq 0.6$. The maximum value for A would then be 1.5 percentage points of pricing authority. Other approaches are possible, such as modulating the increments to accelerate or taper off incentives.

range of TFP growth rates, it could devise a similar formula or specify a number of steps to apply across the preferred range.

In sum, the all-or-nothing two-step function, with three-decimal-place precision, is far more severe than regulatory practice supports. It also diminishes the intended incentive effect by failing to account for the risk that TFP-based authority determinations will reflect normal variations rather than actual management performance. As a first step, the Commission should round the benchmark and measured TFP results to one decimal place, consistent with the historical reporting of TFP growth. The Commission could then more fully correct the “cliff effect” problem in one of two ways. It could award the full 0.75-percentage-point authority if measured TFP growth is within one standard deviation of the benchmark. (There are multiple valid ways in which the Commission could calculate the standard deviation, but it should cover a statistically significant number of years.) Alternatively, it could use a linear, quadratic, or multi-step smoothing function to award increments of the TFP-based authority for incremental performance results within the range.

d. Putting it all together

The Commission’s productivity-benchmarking proposal in Order No. 4258 does not make good on either its stated purposes (including, most fundamentally, supplying additional revenue to start the “harmonious cycle”), its invocation of regulatory best practices, or basic principles of incentive regulation and fairness. As a result, it poses six unnecessary harms, as outlined at the outset of section V.C.4 above. As discussed above, it can most effectively bypass all of these problems by making the entire additional rate authority available unconditionally to fund capital investments. If the Commission determines not to do so, the Commission can and should redesign its benchmarking proposal to fix all of these problems and conform its approach more closely to the established model for similar mechanisms.

First, and most fundamentally, the Commission should make the 0.75 percentage points of additional pricing authority unconditional in the first years, until new-system performance is available for comparison or until, in light of the benchmark level and rolling-average trends, the Postal Service would stand a realistic chance of achieving conditional rate authority. This would be consistent with the rationale of providing the Postal Service with a minimal level of additional revenue to start the "harmonious cycle," and it would allow some time to measure the operation of that cycle.

Second, the benchmark should be updated to reflect the last five years of the current system, with the first measured period commencing with the first year of the new system. The most supportable option is to set the benchmark at FY2014-FY2018. In addition to the logic of comparing pre- and post-new-system performance, the likely lowering of the benchmark would also be consistent with regulatory practice of ensuring that benchmarks are achievable as well as challenging. (Per the previous paragraph, the additional rate authority should be unconditional in the meantime.)

Third, if and when the additional rate authority becomes conditional, eligibility should be based on <u>either</u> the most recent single year's TFP growth <u>or</u> the cumulative average of new-system-period TFP growth (whichever is greater), as compared against the full five-year-average benchmark growth rate. This will ensure that incentives are both effective and fair.

Fourth, the benchmark and measured TFP growth should both be rounded to a single decimal place. This is consistent with longstanding TFP-reporting practice and will avoid arbitrarily severe cliff effects.

Fifth, to ensure that statistical noise does not interfere with incentives, the TFP-based authority should be awarded if measured TFP growth falls within an appropriate range of the benchmark. There are various eminently justifiable options specifying an appropriate range. Alternatively, a smoothing function should allow a portion of the full TFP-based authority to be awarded for positive TFP growth below the benchmark, as well as, possibly, additional rate-authority increments for above-benchmark performance.

These fixes are not particularly daunting or complicated. Updating the benchmark can be easily specified, and single-decimal-place rounding is already reflected in the proposed rules (albeit not in the text of Order No. 4258). Making the first years unconditional should be easy enough to state in the rules. It should not be much more difficult to frame the either/or contingent award along the lines set forth here; as for actual outcomes, that should be simple for stakeholders to derive from TFP data, and the Commission would make the determination clear in the ACD in any case. As for the fifth fix, the acceptance of deadband and smoothing functions in utility regulation suggests that they are not impossibly hard to apply or understand. A deadband can simply be stated as "+/- X percentage points"; a smoothing function can take the form of an exhibit like Table 5 above.

Indeed, if the benchmark period is known at the time of the final rule, the second, fourth, and fifth fixes do not require any narrative elaboration in the final rule at all, but only the choice of a number. For example, while it could be explained in the text of an order that the FY2014-FY2018 benchmark was, say, 0.2 percent and the selected deadband amounted to +/- 0.2 percentage points, all that the proposed rule would need to state would be an effective benchmark of “0.0 percent.” This would also make clear, without further elaboration, that a single decimal place is the key level of precision.

D. The “Service-Standards” Component, While Based on Problematic Premises, Is Unlikely to Pose Undue Difficulties in Practice

As discussed in section II.C.3 above, the Postal Service questions the Commission’s conclusion that any remedy is necessary concerning service standards, as well as its proposed use of pricing authority to place a thumb on the scales of statutorily permitted management decisions regarding service standards. That said, the service standards component of the Commission’s proposed performance incentive mechanism should at least have minimal impact on the Postal Service’s statutory and necessary discretion. Past experience shows that nationwide or substantially nationwide changes in service standards (including business rules) are infrequent, and so the modest additional pricing authority would likely be available to contribute toward financial stability in most or all years. The Commission has appropriately limited the impact on the performance-based authority from any changes in service standards, by proposing to withhold the additional pricing authority only for specific classes with service standard changes and only in the year following a change (rather than for the remainder of the period). And the magnitude of the additional authority is small enough that it is unlikely to deter management from major service standard changes that may be needed in order to increase operational efficiency and that are consistent with the objectives and factors of Section 3691.

Finally, the Commission does well to take a monitoring approach to service performance, rather than to treat it as a reflection of the rate-regulation system's merits. The U.K. experience clearly shows that even a one-percent service performance factor has little real incentive effect, amid other elements of a price cap, and serves only to add complication.[281] Numerous real-world factors, such as weather, influence service performance, and it would be practically impossible to control for such factors and isolate the incentive effect of a price cap factor. The Commission correctly commits service performance issues to the annual compliance review.[282]

VI. CERTAIN ASPECTS OF THE PROPOSED RULE WOULD POSE PRACTICAL DIFFICULTIES AND SHOULD BE CHANGED OR CLARIFIED

A. The Commission Should Allow Supplemental and Performance-Based Rate Authority to Be Banked

The proposed rules would continue to allow unused CPI-based rate authority to be banked, but they do not allow banking for any new type of rate authority.[283] It may be understandable to prohibit the banking of underwater-class rate authority, at least for persistently underwater classes,[284] but it is not clear why the proposed rules would not

[281] USPS March 20 Comments, appx. F at 6-7, 9 fn.30. The French postal regulator also decided against including a service performance factor in the price cap. *Id.* at 25.

[282] Order No. 4258 at 72.

[283] *Id.* at 119-20, 122-23, 125 & att. A at 23-24, 27-28, 31 (proposed Rules 3010.160(b)(5), .180(b)(5), .202(c)(4), .222(b), .224(c)).

[284] The goal of the underwater-class rate authority is to bring the class above-water as soon as possible (in the interest of the allocative-efficiency aspect of objective 1), and it might not be fair to mailers if that rate authority could be saved and used at a later time when the class is no longer underwater. As discussed in section VI.C.1 below, however, the Commission's proposed rules for underwater products, including underwater classes, must be reconciled with its well-reasoned precedent that establishes a more holistic approach to underwater products. As an incidental note, however, the need for proposed Rule 3010.202(c)(4) (stating that underwater-class rate authority may not be banked) is unclear, since the proposed rules would require the Postal Service to use all available rate authority with respect to underwater classes anyway. *See* Order No. 4258, att. A at 26 (proposed Rule 3010.202(b)).

permit banking of supplemental or performance-based rate authority. For those types of rate authority, allowing banking would promote certain statutory objectives without disserving any others. Specifically, permitting the Postal Service to bank supplemental and performance-based rate authority, rather than requiring the Postal Service to forfeit it, would enhance pricing flexibility (objective 4), improve the Postal Service's ability to work toward financial stability and invest in network improvements (objectives 1, 3, and 5), and maintain the reasonableness of rates (objective 8).[285]

Allowing the banking of this additional authority would serve the same purposes as the banking of CPI authority. The additional banked authority would enable the Postal Service to exercise business judgment as to market conditions and business realities. In response to perceived demand risks or other business reasons, the Postal Service could moderate price increases in the near term, while building a rate-authority cushion to account for future contingencies.[286] While disallowing the banking of the additional authority might arguably provide "predictability and stability in rates" if mailers could expect each price increase to equal all of the Postal Service's available rate

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[285] For example, as discussed further in section IV.A above, the proposed supplemental rate authority is designed to do no more than fill in a net-income gap, in five installments. If the Postal Service found it prudent not to use the entirety of a given installment, the no-banking rule would forever remove from the ledger the Postal Service's ability to fill in that portion of the gap. At the end of the five-year period, all other things being equal, the Postal Service would not have garnered all of the additional revenue that the Commission, in crafting the supplemental rate authority, deemed necessary to providing medium-term financial stability. The same applies to the performance-based rate authority and the long-term financial-stability goal of filling the capital-spending gap and promoting efficiency-improving (and service-maintaining) investments. Thus, the no-banking rule would erode the new rate-authority mechanisms' intended ability to achieve objectives 1, 3, 5, and 8.

[286] The past decade shows that, during a contingent event, the Postal Service may lose volume and revenue that are not fully compensated by the mechanism for exigent rate relief, due to the narrow statutory limits on recovery (as applied by the Commission). And then there is the possibility that events might be adverse but not sufficiently "extraordinary or exceptional" to trigger the exigency mechanism in the first place.

authority, it would better serve customer interests at the heart of objective 2 if the Postal Service had the flexibility to exercise pricing restraint, rather than creating a perverse incentive by forever foreclosing the use of additional pricing authority if not used immediately.[287]

To the extent that the Commission believes that some constraint on the use of banked authority is needed, it can impose that constraint by setting an appropriate limit on the use of banked authority. Under the current and proposed rules, the Postal Service can use only up to 2 percentage points of banked authority in any year.[288] While a usage limit is justifiable, the Commission should raise the usage limit in light of the availability of additional authority to facilitate the clearing of accrued banked authority within the five-year period allotted for it.[289] The current 2-percentage point limit may be reasonable in a context where only a relatively limited amount of CPI-based rate authority is available and bankable. If more rate authority is available to the Postal Service and eligible for banking, however, the 2-percentage point limit might result in a backlog and unreasonably restrain the Postal Service's pricing flexibility. The Commission should use its judgment to set a higher usage limit that allows for reasonable use of the bank, while providing mailers with predictability and stability.

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[287] In a related issue, the affirmative mandate to use all available rate authority for underwater classes (proposed Rule 3010.202(b)) could interfere with prudent decision-making in other ways. The Postal Service would be unable to reserve a margin of rate authority for the event of a Commission remand, which could order it to propose further adjustments to price cells or workshare discounts that require the use of rate authority.

[288] 39 C.F.R. § 3010.29; Order No. 4258, att. A at 32 (proposed Rule 3010.225(c)).

[289] Order No. 4258, att. A at 32 (proposed Rule 3010.225(f)).

Allowing the banking of new rate authority would be consistent with recent best practices of other postal regulators that have modernized their price-regulation models. As discussed in section III.B above, U.K. postal regulator Ofcom decided in 2012 to replace the former regulator's complex price cap with a "safeguard cap" on Royal Mail's Second-Class Letters, Large Letters, and Packets. Ofcom set the cap at a level 53 percent higher than then-current prices and indexed it to consumer inflation.[290] This allowed Royal Mail to follow its business judgment as to when and how much to raise prices, based on its assessment of the market. In fact, Royal Mail has not used all of the available cap space; it continues to hold a substantial remainder in reserve.[291] And only a few months ago, the French regulator L'Autorité de Régulation des Communications Électroniques et des Postes (ARCEP) established a 2019-2022 price cap that allows La Poste to raise prices by an average of 5 percent per year.[292] In a departure from the previous price cap, which prescribed the proportion of total cap space available for each year, ARCEP has now allowed La Poste to make its own decisions about how the overall pricing authority should be used across the period, including consumption of the whole period's cap space in a single price increase, so long as the average annual increase equals 5 percent.[293]

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[290] USPS March 20 Comments, appx. F at 11.

[291] *Id.*, appx. F at 11-12.

[292] ARCEP, Décision n° 17-1252 relative aux caractéristiques d'encadrement pluriannuel des tarifs des prestations du service universel postal sur la période 2019-2022 (Oct. 26, 2017), at 6, https://www.arcep.fr/uploads/tx_gsavis/17-1252.pdf.

[293] *Id.* ("*La contrainte tarifaire s'apprécie en moyenne sur la période soumise à encadrement, ce qui en théorie n'interdit pas à La Poste de réaliser la hausse totale consentie par le dispositif de la présente décision en une seule année.*"). ARCEP noted its preference for a "constant rhythm" of 5-percent annual increases, but it did not codify that preference into a binding condition. *Id.* ("*Toutefois, l'Arcep considère préférable que l'évolution des tarifs des prestations du service universel suive un rythme constant dont le niveau ne saurait donc dépasser 5% par an en termes nominaux.*").

Thus, the Commission would be in good company if it allowed the Postal Service to determine when and how best to use its additional cap space.[294] Allowing the banking of supplemental and performance-based rate authority, while maintaining an appropriate (albeit revised) usage limit, would best serve the statutory objectives and be consistent with regulatory best practices.

B. The Commission Should Adjust Certain Timing Provisions to Preserve the Postal Service's Discretion Over the Timing of Price Adjustments

The proposed rules pose three timing issues that hinder the Postal Service's pricing flexibility and, in the case of the latter two, undermine the effectiveness of the Commission's intended remedies. The first issue concerns redundant calendar-year conditions on the applicability of new types of rate authority; together, these conditions would severely narrow the Postal Service's window for making price adjustments. The second and third issues concern the transition to the new system: specifically, when new forms of rate authority will first become available.

1. The Commission should preserve the Postal Service's flexibility as to the timing of price adjustments

Order No. 4258 introduces new timing conditions that would unduly constrain the Postal Service's control over the schedule of price increases. Whether or not intended, the Commission should reconsider or clarify those constraints.

The proposed rules for supplemental, performance-based, and underwater-class rate authority feature a number of time conditions:

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[294] If anything, allowing the banking of supplemental and performance-based rate authority would remain more conservative than the U.K. and French regulators' approaches. The U.K. and French regulators allow free use of a period's cap space at any time, including at the outset of the period, whereas a banking rule would allow the use of unused cap space only after it has accrued.

(b) Any rate authority allocated under this subpart:

(1) Shall be made available to the Postal Service as of January 1 of each calendar year;

(2) Must be included in the calculation of the maximum rate adjustment authority in the first generally applicable rate adjustment filed in any calendar year;

(3) Shall lapse if not used in the first generally applicable rate adjustment filed in any calendar year;

(4) Shall lapse if unused, on December 31 of the applicable calendar year; and

(5) May not be used to generate unused rate authority, nor shall it affect existing banked rate authority.[295]

As explained in section VI.A, it is not apparent why these new forms of rate authority should not be bankable, in the interest of promoting pricing flexibility, ensuring adequate revenues, and other statutory objectives. If the no-banking rule were eliminated, then there would be no need for such conditions as a December 31 expiration or a first-filing use requirement.

Beyond that, the proposed conditions require clarification. It is unclear what it means for rate authority to be “made available” and “used” (or “unused”). By making the rate authority “available” for “use” in a calendar year, is the idea that the relevant price adjustment must take effect within “the applicable calendar year,” regardless of whether the price-adjustment notice was filed in the prior year? If that is the intent, then paragraphs (b)(2) and (3) muddle the issue by requiring the rate authority to be used “in

[295] Order No. 4258, att. A at 23-24, 26-27 (proposed Rules 3010.160(b)(1)-(4), .180(b)(1)-(4), .202(b)(1)-(3)). Oddly, proposed Rule 3010.202(b) does not have a paragraph that parallels proposed Rules 3010.160(b)(3) and .180(b)(3).

the first generally applicable rate adjustment filed in any calendar year": the same "calendar year" phrase used to modify "availability."

Or is the rate authority "used" when the price adjustment notice is filed, as paragraph (b)(3) suggests? In that case, is the intent that the rate authority must be included in a price adjustment notice filed between January 1 and December 31 of the relevant year, regardless of whether the adjustment takes effect that year or the next year? This might be a consistent way to read the term "use" across the various conditions, but it does not entirely agree with the natural inclination to consider rate authority to be "used" when a price adjustment takes effect. After all, an initial price-adjustment notice often is not the final word, as the Commission may remand the adjustment for modifications.

Finally, is the idea that both such readings should apply simultaneously, such that the rate authority must be used in a price adjustment that both is filed and takes effect during the relevant calendar year? If so, that would put an end to the Postal Service's longstanding practice of filing notices in the fall for market-dominant price adjustments that take effect in January of the following year. Due to the need to allow time during the winter months to incorporate Annual Compliance Report data and the common interest in avoiding price adjustments during peak season in late fall, the Postal Service would find itself confined to a window of only about three months (approximately mid-March to mid-June) in which it could file a price-adjustment notice.

This outcome would serve none of the statutory objectives. To the contrary, it would restrict the Postal Service's pricing flexibility (objective 4). It would also run counter to the Commission's traditional deference to the Postal Service's business judgment about when price adjustments should occur. As the Commission has previously recognized, "[t]he Postal Service's pricing flexibility allows the Postal Service to set its schedule of price adjustments and make revisions to the schedule at will."[296] This flexibility should continue, so that the business decision as to when to implement price adjustments is not dictated by technical regulatory considerations. Order No. 4258 contains no indication that the Commission contemplated, much less intended, the rate-authority availability and usage rules to limit the Postal Service's timing flexibility.[297]

To address this constraint on the Postal Service's pricing flexibility, the Commission should reframe its proposed rules so as to continue to allow the filing of notices in one year for price adjustments that take effect in the following year.[298] There is no practical reason why the proposed rules could not accommodate such a practice, since each of the relevant types of rate authority would be established in the ACD issued in the March before the calendar year in question (or, in the case of service-standards-based rate authority, no later than June after that ACD).

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[296] Annual Compliance Determination Report for Fiscal Year 2015, PRC Docket No. ACR2015 (Mar. 28, 2016) [hereinafter "FY2015 ACD"], at 11.

[297] The section-by-section analysis of the relevant proposed rules merely restates the content of the conditions, without justifying them or explaining their interaction. *See* Order No. 4258 at 119-20, 122.

[298] If the Commission keeps conditions based on the date of filing, it should clarify that those conditions apply only to the filing of a "large-scale" price adjustment, and not to "generally applicable" (per the proposed rule) price adjustments that consist solely of promotions, limited price increases, or other small-scale changes. *Compare* Order No. 4258, att. A at 5-6 (proposed Rule 3010.101(j) (defining "rate of general applicability" to mean, essentially, any price not established through a negotiated service agreement) *with, e.g., id.* at 23 (proposed Rule 3010.160(b)(2)-(3)) (requiring supplemental rate authority to be used in the "first generally applicable rate adjustment" of the calendar year). This would be consistent with past practice. In its ACDs, the Commission frequently requires the Postal Service to align workshare discounts in "the next Market Dominant price adjustment." *E.g.*, Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2016 (Mar. 28, 2017) [hereinafter "FY2016 ACD"], at 14; FY2015 ACD at 12-14. Sometimes, the Commission refers to "the next general Market Dominant price adjustment." FY2016 ACD at 26, 32, 40. Regardless of the precise wording, the requirement has been applied to the annual omnibus price adjustment, rather than preceding minor cases, such as those establishing promotions.

2. The Commission should clarify that performance-based and underwater-class rate authority will be available for the first price adjustment following the new rules

As proposed, the Commission would determine a given calendar year's performance-based and underwater-class rate authority on the basis of the ACD issued in the preceding calendar year.[299] Because administrative rules typically have only prospective effect,[300] it is clear that the new rate authority would first become available in a calendar year following the final rules. Less clear is whether it would become available in the first post-rule calendar year, or not until the first calendar year after the first post-rule ACD. For example, if the final rule is issued in 2018, the question would be whether the performance-based and underwater-class rate authority would first become available in 2019 or 2020.

With respect to the proposed performance-based rate authority, the transitional issue would become moot if the rate authority were made unconditional until the next Section 3622(d)(3) review or, with respect to the operational-efficiency component, at least until 2021, as proposed in section V.B and V.C above.

Failing that, and with respect to the underwater-class rate authority in any case, the Commission should clarify that all new rate authority will become available for a price adjustment effective in 2019, without having to await a post-rule ACD. The performance-based rate authority and underwater-class rate authority are designed as remedies to specific and fundamental problems that the Commission identified in the current system as of FY2016. Once the Commission has established remedies for

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[299] Order No. 4258 at 120, att. A at 5, 23-26 (proposed Rules 3010.101(f)-(g), .180-.182, .200-.202).

[300] *See* 5 U.S.C. § 551(4).

those problems, there is no reason to delay implementation of those remedies for an entire year, particularly since the other proposed remedial mechanism (supplemental rate authority) would become available sooner.

Practical considerations do not require a delay. All of the facts needed to determine eligibility for the remedial mechanisms, such as the roster of underwater products and any changes in service standards, should be apparent from the FY2017 ACD or from other information available to the Commission.[301] If any further fact-finding is required, that can be done through a special transitional proceeding or in the course of the first price adjustment case. All forms of new rate authority should become available on the same schedule, as soon as possible following the final rule.

3. The Commission should allow an opportunity to start fixing the current system's problems as early as possible

As discussed in the preceding two sections, the Commission proposes to make the new supplemental rate authority (and, hopefully, other new types of rate authority) available in the first full calendar year following the new rule. For example, if the final rule arrives in 2018, the new rate authority would take effect in 2019. If the final rule does not appear until January 2019, however, the Postal Service would not be able to use the new authority – and start addressing the current system's failings as of FY2016 – until 2020. To avoid this result, the Commission should make the new authority

[301] As discussed in sections V.C.1 and V.C.4.a above, if the Commission retains a TFP-linked form of rate authority in its final rule, new-system-era TFP growth data will not be available until March 2020, for potential use in setting rate authority for 2021. That is not a reason to defer making that rate authority available until 2021, however, given that it is intended as a remedy for the established problem of insufficient capital investment. As discussed in section V.C.4.a, the best option is to make the rate authority available unconditionally for at least the first years of the new system, consistent with the Commission's acknowledgment that some additional retained earnings are needed at the outset in order to start the "harmonious cycle."

available in either the same calendar year as the final rule or the following calendar year. It would be the Postal Service's option to decide when the new authority takes effect.

This approach would provide the Postal Service with appropriate flexibility to respond to internal and external business needs. The same-year option would allow for early implementation and remediation, while the following-year option would be available for when the Postal Service does not deem there to be enough time left in the year to prepare and file a price adjustment, or when business reasons justify deferring implementation.

Particularly if the Commission decides to maintain a time limit on one or more forms of rate authority (such as the five-year limit on supplemental rate authority), leaving the new system's start date (within the first two calendar years) to the Postal Service's business judgment would avoid forcing the Postal Service to forfeit a year's worth of new rate authority if its business judgment supports a start date in the later year.[302] The new system's problems are well-established; fixing them need not await a turn of the calendar.

[302] This principle could be thought of as a tolling rule that shifts the entire five-year period of the supplemental rate authority. That is, if the new rule took effect in 2018 and the Postal Service made its first price adjustment in 2018, the supplemental rate authority would run from 2018 to 2022. If the Postal Service instead made its first price adjustment in 2019 (perhaps because not enough time was left in 2018), that should not cause the Postal Service to "lose" a year of supplemental rate authority. Rather, it should run from 2019 to 2023, as under the proposed rules.

C. The Proposed Rules for Underwater Products Warrant Some Pragmatic Changes

1. Forced rate-rebalancing should be a last resort, not a first resort

To address underwater products within an above-water class, the Commission proposes to force a reallocation of pricing authority, with 2 percentage points above the class average going to the underwater products, and below-average pricing authority remaining available for the other products in the class.[303] It may be that the Commission sees this as the least problematic alternative, although the Commission does not articulate any other alternatives (such as providing additional price cap authority) beyond merely different percentage-point values. It is notable, however, that this remedy would address an aspect of one objective (allocative efficiency, which the Commission has articulated as being embedded within objective 1) only at the expense of another objective: the Postal Service's pricing flexibility (objective 4). It is hard to see how this fits with the Commission's view that "the application of each objective is conditioned upon the need to recognize and reflect the others."[304]

To address the allocative-efficiency problem in a way that "recognizes and reflects" the pricing-flexibility objective, the Commission should hold the forcible reallocation of pricing authority in reserve. Such a drastic remedy should not be applied as a first resort, but as a last resort for truly persistent negative-cost-coverage situations, after the Commission concludes that other efforts to improve cost coverage have failed.

[303] Order No. 4258 at 77-80, 121 & att. A at 25 (proposed Rule 3010.201).

[304] Order No. 4257 at 17 (quoting Order No. 536, Order Adopting Analytical Principles Regarding Workshare Discount Methodology, PRC Docket No. RM2009-3 (Sept. 14, 2010), at 36).

This would be consistent with longstanding Commission practice. In Order No. 1427, the Commission decided that it would take a holistic approach to determining the "extreme circumstances" in which an underwater product warrants a rate remedy.[305] Under 39 U.S.C. § 101(d)'s "fair and equitable apportionment of costs" standard,

> it is fair and equitable for products to recover their attributable costs. That conclusion, however, does not mean that any time rates for a product fail to cover attributable costs the Commission will automatically, pursuant to 39 U.S.C. § 3653, find the Postal Service out of compliance and order remedial action. The totality of circumstances presented is critical to Commission evaluations under section 3653. For example, did costs unexpectedly spike during the preceding year? Has the situation persisted for some time? If so, what remedial steps has the Postal Service taken?[306]

The Commission enumerated six factors that it would analyze to determine, based on the preponderance of those factors, whether an underwater product was a suitably "extreme case."[307] As the Commission acknowledged, such a finding "would not be justified, if, for example, the Postal Service had not yet had a reasonable opportunity to remedy the shortfall" or "if the Postal Service were to demonstrate that price increases would be counterproductive under the statutory price cap or that cost reductions were not feasible."[308] Although Order No. 1427's thoughtful "totality/preponderance" approach focused putatively on the application of 39 U.S.C. § 101(d) rather than

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[305] Order No. 1427, Order on Remand, PRC Docket No. ACR2010-R (Aug. 9, 2012), at 9. Although this discussion focuses on the Commission's proposed rate-rebalancing remedy, the Commission may also need to address past precedent in the context of its proposed rules for underwater classes, which Order No. 4258 bases strictly on underwater status without regard to factors like the persistency of that status.

[306] *Id.* at 4.

[307] *Id.* at 9-10.

[308] *Id.* at 10.

objective 1 or factor 3, the unqualified rate-remedy-as-first-resort proposal in Order No. 4258 would render it a dead letter, without any apparent justification.[309]

Consistent with Order No. 1427, the Commission's practice in subsequent annual compliance reviews has recognized that the underwater status of a product does not invariably require immediate resort to remedial above-average price increases. In some circumstances, the Commission has taken a "wait and see" approach to underwater products, particularly lower volume products, in the interest of gathering more information about the product's apparent non-compensatory status.[310] At other times, the Commission has declined to direct remedial pricing action, in light of special circumstances concerning an underwater product.[311] The Commission has also commended the Postal Service for voluntarily applying above-average price increases to an underwater product, even when those price increases were less than 2 percentage points above the class average.[312] In at least one instance where the Postal Service's "appropriate," voluntary above-average price increases did not keep pace with unit cost increases, the Commission focused its directive on "opportunities to

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[309] *U.S. Postal Serv. v. Postal Regulatory Comm'n*, 842 F.3d 1271, 1273 (D.C. Cir. 2016) (holding that the Commission failed to engage in reasoned decision-making when it "neither acknowledged a change in course nor explained it"). *See also* Order 4402, Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products (Feb. 8, 2018), at 11 (discussing the need to acknowledge and explain a change in position).

[310] *E.g.*, FY2016 ACD at 62 (finding that Collect on Delivery was underwater and directing the Postal Service to provide additional information about cost sampling in its next annual compliance report).

[311] *Id.* at 60 (ordering no remedy for Stamp Fulfillment Services, because "the financial performance of SFS does not entirely capture the value that the Services Center adds to the Postal Service and to other Postal Service products," and in light of the fact that "product cost coverage is improving yearly").

[312] *Id.* at 71 (hailing the Postal Service's above-average price increases for Media Mail/Library Mail as "appropriate"). As the table on the same page shows, six of the seven above-average price increases for Media Mail/Library Mail were less than two percentage points above the class-average pricing authority available at the time.

further reduce the [product's] unit cost," rather than on even higher above-average price increases.[313] It is also possible that, given the six-month lag between the end of the fiscal year and the Commission's determination, an intervening price or costing change may have brought a formerly underwater product above water, such that it needs no further remedy.[314] In a decade with many persistent and intermittent underwater products, the Commission has never found fault with a multi-pronged approach to cost coverage, nor has it sought to wrest control of pricing by demanding aggressive above-average price increases in all circumstances.

Therefore, the Commission has recognized that statutory policies against underwater products do not justify the strict, "one-size-fits-all" pricing approach that it mandates here. The Commission should continue its longstanding holistic approach and leave its proposal of mandatory rate-rebalancing for a last resort, to be deployed only when other options have truly failed. The proposed rules can easily be amended to reflect such an approach. When the Commission makes its findings of non-compensatory status in the ACD, it can target certain products for application of rate-rebalancing. To increase the certainty to interested parties, the Commission could even provide criteria in its rules for the application of the remedy, such as the number of years that a product must be persistently underwater with no sign of improvement. In place of the approach proposed in Order No. 4258, the Commission could craft a measure that would, through the specter of specific Commission intervention, enhance

[313] *Id.* at 59 (Standard Mail Parcels).

[314] Or close enough that positive cost coverage could be achieved with less than a 2-percentage-points-above-class-average price increase.

the Postal Service's incentives to use its pricing flexibility and understanding of its cost structure to fix underwater products.[315]

2. Any "no-price-reduction" rule should apply at the product level

For any underwater product (whether or not in an above-water class), the Commission proposes that "rates may not be reduced."[316] It is not clear whether this is meant to apply on a product-average basis or at the level of each individual price cell. If implemented, the Commission should clarify that this rule applies at the product level. Applying it at the price-cell level would unduly constrain pricing flexibility and could get in the way of fixing compliance issues, such as with the Commission's proposed workshare rules or with the statutorily mandated ratio between commercial and nonprofit Marketing Mail revenue.[317]

D. Even with Three Specific Changes to the Proposed Workshare Discount Rules, Difficulties with Compliance May Persist

The Postal Service continues to believe that the Commission should not subject workshare discounts to a passthrough floor as well as a ceiling. The Commission's decision to impose rigid compliance bands in pursuit of efficient component pricing inhibits the Postal Service's pricing flexibility, and it is not necessary in order to

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[315] At the very least, the Commission should give the Postal Service an opportunity to request a temporary waiver of the rate-rebalancing remedy, to allow additional time to gauge the effects of intervening or planned price increases, cost reductions, or costing methodology changes. The Commission could also create more permanent exceptions for products that it considers to provide value notwithstanding their facially underwater status, like Stamp Fulfillment Services, and for those whose underwater status cannot clearly be determined, like Collect on Delivery service.

[316] Order No. 4258 at 117, 118; *id.*, att. A at 14, 20 (proposed Rules 3010.127(b) & .129(g)).

[317] If the Commission insists on constraining the Postal Service's pricing flexibility for underwater products below the product level, it should at least carve out an exception to that constraint where price-cell reductions are needed to fix a workshare discount or meet other identified business needs. But the Postal Service believes that a product-level constraint would better achieve the statutory objectives (in particular, allowing pricing flexibility).

effectuate objective 1. Moreover, passthrough ratios can shift significantly from price change to price change and from one annual compliance review to the next, due to non-pricing factors like changes in costing methodology or changes in mail mix and operational efficiencies. Creating even more reasons to continually adjust prices on the basis of such exogenous changes would erode the predictability and stability of workshare prices, thereby implicating objective 2.

That said, the Postal Service proposes only three specific changes to the proposed rules. First, the exceptions and limitations in Section 3622(e)(2)-(3) should be retained to justify outside-band passthroughs on a case-by-case basis. For example, the exception for “mail matter of educational, cultural, scientific, or informational value” in Section 3622(e)(2)(C) may be needed to allow reasonable pricing flexibility in Periodicals.

Second, the Commission should allow for expansion of the bands in cases where the cost avoidance is so small that any deviation from 100 percent passthrough would fall outside the compliance bands. For example, a cost avoidance of $0.006 for a non-Periodicals workshare category would have no compliant discount other than $0.006, since the passthroughs for discounts of $0.005 and $0.007 would fall outside the 85-115 percent passthrough band. In the interest of promoting pricing flexibility and allowing for normal variability in passthrough ratios, a limited range of compliant price points (at least the cost avoidance +/- $0.001) should be provided at all times.

Third, the Commission should also adjust the precise timing of the three-year grace period. Under proposed Rule 3010.262(a), the grace period would begin as soon as the rules become final. Because of the time needed to prepare the filing, and the desire to maintain the timing of regular and predictable rate changes, the Postal Service might not file its first price change under the new rules for several months. This would remove one of the three grace-period price changes that the Postal Service believes to be necessary to move passthroughs closer to the new passthrough bands. The Postal Service also remains concerned that cost avoidance changes before the first price change after the grace period might make compliance with the band impractical or inefficient in some limited cases. The Postal Service therefore requests that proposed Rule 3010.262(a) be changed so that the grace period starts with the implementation date of the first general price change after the effective date of the new rules. The Postal Service would like to have four opportunities to bring passthroughs within the bands: three annual price changes during the grace period, and then a fourth price change that would bring all passthroughs within the bands.

Practical experience will ultimately be the test of the Commission's proposed approach, if implemented, and it may be that workshare passthroughs will sometimes be difficult to herd into compliance. At any rate, implementation of the proposed rule may lead the Postal Service to reconsider which workshare discounts are worth offering. For instance, in order to avoid undue constraints on its pricing flexibility, the Postal Service might find that combining types of mail for pricing purposes might be more effective than retaining different price cells for mail that varies by factors of limited distinction for processing and pricing purposes.

E. The Commission Should Reconsider Its Proposed Changes to Price-Adjustment Case Schedules

1. The Commission's proposed extension of the decision timeframe would pose serious practical problems

While the Commission purports only to codify existing practice with its proposed revisions to the procedural schedule,[318] the proposed rules would actually create material changes and increase uncertainty for the Postal Service and mailers. The overall 90-day notice proposal largely tracks existing practice for what the Commission calls "large-scale price adjustments," but the Commission's proposal to extend procedural deadlines creates practical problems and is inconsistent with objectives 2, 5, and 6.

Under the current rules, the Commission announces its decision regarding a price adjustment 34 days after the initial filing.[319] As the Commission has noted, however, most of the PAEA-era price-adjustment cases have presented "significant issues" that require the Postal Service to return to the Commission with amended rates.[320] With a 34-day initial decision period, the Postal Service has enough time to prepare and file an amended notice at least 45 days in advance of the originally scheduled implementation date, as required.[321] There is also time for the Commission to conduct any necessary proceedings well in advance of the implementation date. The current procedural rules give the Postal Service a second chance to fix any errors while

[318] Order No. 4258 at 104-05.

[319] 39 C.F.R. § 3010.11(a)(5), (d).

[320] Order No. 4257 at 72 ("In six of the eight large-scale price adjustment proceedings, there were significant issues with the Postal Service's notices of price adjustment filings resulting in durations of between 58 and 112 days.").

[321] 39 U.S.C. § 3622(d)(1)(C); 39 C.F.R. § 3010.11(i).

preserving the predictability and stability of the mailing community's expectations around the price-adjustment schedule.[322]

The proposed rules would no longer do that. The Commission proposes to allow more time for comment and for its decision, with the latter coming 51 days after the initial filing.[323] But it is unclear why the Commission is proposing this change. The Commission cites no comment complaining that the current schedule fails to "facilitate meaningful and intelligent participation by interested persons" or to adequately "allow the Commission to evaluate each rate proceeding."[324] If anything, the history recounted in Order No. 4257 illustrates that the current procedural schedule works well in allowing mailers and the Commission to identify issues for the Postal Service to resolve through a single remand.

Meanwhile, the proposal would create new problems. Although the Commission has the power to modify the statutory requirements for the initial rate-regulation system, its proposed rules would preserve the requirement that amended rates be filed 45 days before their implementation date.[325] Assuming that the Postal Service files 90 days before implementation, the proposed rules would put the Commission's initial decision on day 51, providing only 39 days before the original implementation date. This would

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[322] As the Commission has noted, even with amended filings, the average "large-scale" post-PAEA price-adjustment case has lasted 62 days, leaving a 28-day period after the final decision for the Postal Service and mailers to prepare for implementation of the approved rates. Order No. 4257 at 72, 75. *See also* 39 C.F.R. § 3010.11(h) (providing for a Commission order 14 days after the amended filing). While multiple remands might require deferral of the implementation date, there has only been one such case among the nine post-PAEA price adjustments. Order No. 4257 at 72; *see generally* PRC Docket No. R2018-1 (concluded Dec. 15, 2017).

[323] Order No. 4258 at 104, 106.

[324] *Compare id. at* 104 (discussing the rationale for the proposed changes) *with id.* at 103 (recounting comments that discuss only a 90-day overall notice period).

[325] *Id.* at 106, 129 & att. A at 13 (proposed Rule 3010.126(h)).

make it impossible to maintain the original implementation date in the (historically likely) event that the Commission considers it necessary to require a remand. Implementation would have to be deferred as a result of any remand, not just in the rare case with successive remands. The Postal Service and mailers would no longer be able to rely on planned implementation dates. This runs counter to both the objective of promoting predictability and stability in rates, and the uncontroverted comments about mailers' need for consistent budgeting expectations.[326] It also increases the administrative burden of the ratemaking system, contrary to objective 6, and could require the Postal Service to delay the receipt of significant additional revenue due to what may be comparatively minor issues with its filing, contrary to objective 5.

Whatever changes to the procedural schedule the Commission wishes to make, it should ensure that the new rules do not increase uncertainty. The simplest option is to codify the 90-day overall notice requirement but leave the timeframes for Commission decisions unchanged: again, no commenter raised an issue with them. If the Commission is determined to increase the decision timeframes, then it could shorten the pre-implementation-notice window to a little less than 45 days. The Commission should bear in mind that mailers and the Postal Service need to know the prices with certainty several weeks before the implementation, to complete the needed programming, roll-out, and testing.[327] A change along the lines recommended here would benefit the entire postal community, while furthering the statutory objectives.

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[326] Order No. 4257 at 53; Order No. 4258 at 100-101.

[327] The Commission's proposed rules would provide for a 31-day review period after the Postal Service's respond to a remand order. Order No. 4258, att. A at 12-13 (proposed Rule 3010.126(e)-(f)). This would not provide enough time for rate certainty before implementation, since typically rates are rolled out for testing purposes about two weeks before implementation. One option that the Commission should <u>not</u>

2. The Commission should preserve the possibility of less than 90 days' notice in appropriate cases

An absolute requirement of 90 days' advance notice would be stricter than existing practice in another regard. While it is true that the Postal Service has generally provided more than 90 days' advance notice notwithstanding the 45-day requirement, there have been cases – presumably of the type that the Commission regards as "small-scale" – where the Postal Service has provided less notice. For example, in Docket No. R2014-1, the Postal Service filed notice of the addition of Alternate Postage Payment to First-Class Mail only 57 days in advance of the effective date.[328] The Commission has acknowledged that "small-scale" cases have been concluded, on average, within 37 days,[329] easily accommodating 45 days' pre-implementation notice. No party complained that insufficient notice was provided in "small-scale" cases, let alone that 90 days' notice should be mandatory.

If the Commission is committed to preserving before-the-fact regulatory review of price changes (unlike in the Postal Service's proposal), then it should recognize that 90 days' notice may be unnecessary for "small-scale price adjustments." In the interest of pricing flexibility, it should preserve the existing practice of allowing the Postal Service to file small-scale cases at least 45 days in advance of implementation. The Postal Service would, of course, retain the option to provide longer notice in "small-scale" cases where it deems appropriate, based on its consultations with mailers.

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pursue is to lengthen the overall 90-day notice window: doing so would move up the Postal Service's internal pre-filing processes unduly, particularly in light of the Commission's proposal to base certain aspects of pricing authority on the outcome of the Annual Compliance Determination.

[328] United States Postal Service Notice of Market Dominant Classification and Price Changes for the Alternate Postage Payment Method, PRC Docket No. R2014-1 (Nov. 5, 2013), at 1.

[329] Order No. 4257 at 72 fn.141, 75, 98; Order No. 4258 at 103.

VII. THE COMMISSION SHOULD TAKE THIS OPPORTUNITY TO CORRECT OTHER ISSUES WITH EXISTING RULES

A. Inbound International Products Should Be Excluded from the Price Cap

This docket presents an opportunity for the Commission to revisit its decision in Order No. 43, where the Commission provisionally decided to include Inbound Letter Post within the initial price cap system, while inviting reconsideration of that decision later.[330] Application of a price cap to Inbound Letter Post does not serve the statutory objectives. Indeed, the proposed rules in Order No. 4258 offer a clear illustration of the problems with subjecting Inbound Letter Post to the price cap. Many of the same problems arise in the context of the International Ancillary Services product, the finances of which are dominated by Inbound Registered Mail.

Inbound Letter Post rates are comprised of so-called "terminal dues": the rates that foreign postal operators pay the Postal Service for delivery of foreign-origin letters, cards, small packets, and M-bags in the United States. The Universal Postal Union (UPU) sets terminal dues rates according to a formula, which

> depend[s] on several factors over which the Postal Service has little or no control, such as currency conversion rates, or increases in the UPU terminal dues cap rates set by the 191 UPU member countries every four years at the UPU Congress. These types of variables are not directly affected by the factors which influence measures of domestic inflation.[331]

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[330] Order No. 43, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, PRC Docket No. RM2007-1 (Oct. 29, 2007), at ¶ 3038 fn.49 (indicating that, "while the Commission has declined to exercise its discretion [not to apply the price cap to Inbound Letter Post] at this time, should circumstances change the Postal Service may request that the issue be revisited").

[331] Reply Comments of the United States Postal Service in Response to Order No. 26, PRC Docket No. RM2007-1 (Oct. 9, 2007), at 73 [hereinafter "USPS RM2007-1 Reply Comments"]. *See also* Initial Comments of the United States Postal Service in Response to Order No. 26, PRC Docket No. RM2007-1 (Sept. 24, 2007), at 15, 20 [hereinafter "USPS RM2007-1 Initial Comments"] ("[With respect to terminal dues], the interests of the United States are to be represented by the State Department, which must negotiate and conclude instruments based in part on geopolitical considerations and the dynamics of the UPU's one country-one vote system.").

As the "designated operator" for the United States, the Postal Service is bound to conform its operations to the provisions of the UPU Acts, including in the application of terminal dues rates.

In Order No. 43, the Commission decided to include terminal dues for inbound international mail within the price cap.[332] But the intervening years of price-adjustment cases have shown that this has no effect on actual Inbound Letter Post rates. UPU decisions, the dynamics of foreign postal markets, and currency exchange markets set the tide of Inbound Letter Post rates, and the amount of First-Class Mail price cap space available to the Postal Service ebbs and flows with those outside forces.[333] To the extent that terminal dues rates might increase faster than the CPI price cap, those outside forces lead terminal dues rates to consume a disproportionate amount of limited cap space and thereby constrain the Postal Service's room to adjust those First-Class Mail prices over which it <u>does</u> have discretion. At other times, terminal dues rates may increase more slowly than CPI and thereby free up additional cap space for other First-Class Mail prices. Price cap treatment of Inbound Letter Post does not enhance consumer protection and Postal Service accountability: despite the Postal Service's putative monopoly for subsets of Inbound Letter Post, its lack of pricing power renders it unable to abuse any such monopoly status. Paradoxically, the only effect of price cap treatment is to expand the influence of unaccountable outside forces, by translating their

[332] Order No. 43, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, PRC Docket No. RM2007-1 (Oct. 29, 2007), at ¶¶ 3034-3038.

[333] *See* USPS RM2007-1 Initial Comments at 21 ("A third reason [for special regulatory treatment of inbound terminal dues] is the general unsuitability of using a price cap to regulate inbound international market-dominant mail. Regulation of inbound charges under a price cap would be inappropriate because such charges are driven, in part, by the votes of UPU members, and, in part, by the influence of exchange rates, which do not necessarily reflect domestic inflation.").

direct impact on Inbound Letter Post rates into an indirect impact on domestic mailers' First-Class Mail rates as well.

It is difficult to square the Commission's decision with the statutory objectives. Allowing outside forces to determine the allocation of First-Class Mail price cap space robs the price cap of its intended transparency, predictability, and stability (objectives 2 and 6). It diminishes the Postal Service's pricing flexibility and hampers its ability to garner adequate revenues from First-Class Mail (objectives 4 and 5). The effect on the Postal Service and mailers is neither just nor reasonable (objective 8). No other objective is served by the inclusion of Inbound Letter Post in the price cap.

The Commission's proposed rule would only exacerbate this incompatibility of cap treatment for Inbound Letter Post with the statutory objectives. In an effort to address issues of allocative efficiency (which the Commission identified as included in objective 1), proposed Rule 3010.201 would require the Postal Service to remedy any product whose attributable costs exceed revenues (according to the most recent ACD) by devoting an above-average amount of the class's cap space to that product. The Commission expressly cited Inbound Letter Post as an example of a product at which this proposed rule was aimed.[334] Yet the Postal Service does not set Inbound Letter Post rates, and so it cannot comply with any sort of pricing mandate. Because this problem cannot be fixed by the regulatory system, Inbound Letter Post should be excluded from the system.

Because the current approach fails to serve any of the statutory objectives that the ratemaking system must be "designed to achieve," 39 U.S.C. § 3622(b), the

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[334] Order No. 4258 at 74-75.

Commission should reconsider Order No. 43 in an effort to fulfill at least some of the objectives. The Commission's decision in Order No. 43 was not a foregone conclusion: the Commission could just as easily have determined that the policies behind regulation of the Postal Service's market-dominant pricing activities are a poor fit for terminal dues, over which the Postal Service has no control, and which are paid by foreign postal operators, not ordinary consumers, in any event.[335] At the very least, the Commission could have created an adjustment factor to buffer the Postal Service's First-Class Mail pricing flexibility against the tides of terminal dues.[336] Those alternatives remain at hand. Either of them would render the price cap's application more just and reasonable and would lift this unnecessary source of unpredictability and instability from other First-Class Mail users.

To the extent that the Commission might once have conceived of price-adjustment cases as a venue for transparency and public comment on terminal dues, alternative regulatory venues now exist. Since 2007, the Commission established formal processes to collect public input on changes to the UPU Acts that affect market-dominant rates and classes, in order to aid in developing the "view" that the

[335] *See* USPS RM2007-1 Initial Comments at 15, 20-21 ("To the extent that the CPI-U price cap is viewed as a protection for Postal Service customers, those protections have no relevance to foreign originators of inbound international market-dominant mail. Whatever protections are accorded foreign mailers are the responsibility of the foreign posts, their regulators, and their governments. Foreign postal administrations can protect their customers through domestic regulatory systems, and can represent their customers' interests in delivery charges paid to other postal administrations, including the Postal Service, through participation in the UPU and through negotiating bilateral contractual agreements or commercial contracts."). In doing so, the Commission could also have recognized that the PAEA provides a separate method – one that better accounts for the vesting of responsibility in the State Department, not the Postal Service, for U.S. policy regarding influence how the UPU sets terminal dues – whereby the Commission offers authoritative opinions on whether changes to terminal dues comport with the PAEA's requirements for market-dominant products. 39 U.S.C. § 407(c); USPS RM2007-1 Initial Comments at 16-17.

[336] *See* USPS RM2007-1 Reply Comments at 72-76 (proposing a terminal dues adjustment factor for outbound international mail).

Commission provides the State Department pursuant to 39 U.S.C. § 407(c).[337] More so than ratemaking proceedings, these processes offer specific insight into and public discussion of the formulation of and policies behind terminal dues rates.[338] Evaluation of the financial impact of terminal dues rates also occurs through the Postal Service's periodic and annual reports.[339] As such, due process and considerations can no longer justify the inclusion of terminal dues in price cap cases.

The foregoing discussion applies equally to the International Ancillary Services product. That product includes some international services over which the Postal Service has pricing discretion, but it also includes inbound international services whose rates are set by the UPU, just as terminal dues are. As shown in the FY2017 ACR, International Ancillary Services did not cover its costs.[340] This was chiefly due to the UPU-set Inbound Registered Mail rates, which dominate the product's finances. Thus, despite the presence of some Postal-Service-determined price categories within International Ancillary Services, the Postal Service lacks the ability to effectively manage the product's prices. Application of the proposed rule's rate-rebalancing

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[337] *See generally* PRC Docket No. IM2016-1 (opened Apr. 20, 2016); PRC Docket No. PI2012-1 (opened July 31, 2012). The Commission's formal Part 3017 rules for such proceedings were codified in 2015. Order No. 2960, Order Adopting Final Rules on Procedures Related to Commission Views, PRC Docket No. RM2015-14 (Dec. 30, 2015).

[338] In Docket No. IM2016-1, for instance, the Commission publicly posted UPU proposals, explanatory Congress documents, and the draft revised version of the entire Universal Postal Convention, as well as links to the Impact Tool on the UPU website. Notice of Posting of Document, PRC Docket No. IM2016-1 (July 20, 2016); Notice of Posting of Document, PRC Docket No. IM2016-1 (July 14, 2016); Notice of Posting of Document, PRC Docket No. IM2016-1 (June 20, 2016).

[339] *See* Order No. 3047, Order Granting, in Part, Request for Data and Explanations, PRC Docket No. IM2016-1 (July 14, 2016), at 6-7 (discussing these data sources and finding no need for intervenors to access non-public financial data or data not already filed in other venues).

[340] United States Postal Service FY 2017 Annual Compliance Report, PRC Docket No. ACR2017 (Dec. 29, 2017), at 43-44.

principle to International Ancillary Services would be as ineffective as its application to Inbound Letter Post.

The last decade of experience has shown that the approach in Order No. 43 is neither necessary nor appropriate in serving the statutory objectives. By contrast, removal of terminal dues and other UPU-determined rates from the price cap (or the introduction of an adjustment factor that zeroes out their impact) would provide pricing flexibility, make a positive contribution (however minor) toward financial stability and related objectives, and promote greater fairness, reasonableness, stability, and predictability in rates, without harming any other objectives. The Commission should therefore reconsider this aspect of Order No. 43 and remove Inbound Letter Post and International Ancillary Services from the price cap.

B. Negotiated Service Agreement Volumes Should Not Be Counted Against Separate, Capped Products

The Commission should also take this opportunity to revisit Rule 3010.24. This rule requires volumes sent under negotiated service agreements (NSAs), which are not subject to the price cap, to be included in billing determinants used for price cap calculations "as though they paid the appropriate rates of general applicability," to the extent practical.[341] The Commission should go beyond its proposal simply to renumber this rule; "chang[ing its] meaning or operation" is actually what is warranted.[342]

The use of uncapped NSA volumes to determine cap space for non-NSA products is at tension with other Commission decisions in Docket No. RM2007-1. The

[341] 39 C.F.R. § 3010.24(a).

[342] Order No. 4258 at 117.

Commission decided that each NSA is a separate product distinct from any "general applicability" product.[343] And the Commission decided that NSA rates should neither be subject to the price cap nor play a role in cap calculations.[344] In no other situation are one product's volumes grafted onto an entirely separate product to inflate the second product's share of cap space. If an NSA is its own product, as the Commission has decided, then the same principle should logically apply. Yet the Commission's rules work a purely punitive effect: the Postal Service gets no additional cap authority when it offers discounted rates through an NSA, yet the NSA's volumes are used to weight a (non-discounted) product. Depending on whether the non-discounted product's prices are above or below the class average, the effect is to diminish or expand the Postal Service's cap authority for that product's class, even though the added volumes do not pay the prices that they are weighting. This effect saps the Postal Service's pricing flexibility (objective 4), is neither just nor reasonable (objective 8), and hardly incentivizes the Postal Service to pursue NSAs, as factor 10 intends.[345]

The regulatory history supports the exclusion of NSA volumes. In a section of Order No. 26 entitled "Treatment of volume associated with negotiated service agreements," the Commission claimed that its proposed rules "exclude the effects of negotiated service agreements from the calculation of percentage change in rates."[346]

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[343] Order No. 43, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, PRC Docket No. RM2007-1 (Oct. 29, 2007), at ¶ 2177; Order No. 26, Order Proposing Regulations to Establish a System of Ratemaking, PRC Docket No. RM2007-1 (Aug. 15, 2007), at ¶ 3079.

[344] *Id.* at ¶ 2080.

[345] No other objective or factor appears to be served by the rule.

[346] Order No. 26, Order Proposing Regulations to Establish a System of Ratemaking, PRC Docket No. RM2007-1 (Aug. 15, 2007), at ¶ 2080 (emphasis added).

The Commission purported to side with mailing-industry commenters on this issue, who advocated the exclusion of NSA rates and volumes from the cap calculation, and it claimed to reject the Postal Service's argument for including NSA rates and volumes in the cap calculation.[347] Yet, without explaining the connection between the two positions, the Commission spent the next paragraph of the order outlining how its proposed rule (now Rule 3010.24) would include NSA volumes in the cap calculation.[348]

Given the lack of clear explanation behind Rule 3010.24 and its disservice to statutory objectives and factors, the Commission should take this opportunity to reconsider and reverse the rule.

C. The Commission Should Provide a Path to Modernizing the Mail Classification System

With this review proceeding, the Commission now has the power to make a change that it had previously recommended to Congress. Section 3622(d)(2)(A) locked the initial price cap system into the mail classes defined in the Domestic Mail Classification Schedule as of the PAEA's enactment, which themselves had not changed materially for years prior to the PAEA. Contrary to Section 3622's theme of modernizing the rate-regulation system, this freezing of mail classes prevented the

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[347] *Id.* at ¶¶ 2079-2080; *see also* Comments of National Newspaper Association in Response to PRC Proposed Regulations Establishing a System of Ratemaking, PRC Docket No. RM2007-1 (Sept. 24, 2007), at 11; Comments of Advo, Inc. in Response to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking, PRC Docket No. RM2007-1 (June 18, 2007), at 4-5. While the Postal Service's comments included references to including NSA volumes in cap calculations, those references arose in the express context of the Postal Service's broader position that cap calculations should account for price decreases (or increases) offered through NSAs. *See* Reply Comments of the United States Postal Service on the Second Advance Notice of Proposed Rulemaking, PRC Docket No. RM2007-1 (July 3, 2007), at 6-7; Reply Comments of the United States Postal Service, PRC Docket No. RM2007-1 (May 7, 2007), appx. C at 13 fn.7. Regardless of the merits of that argument, it has never been the Postal Service's position, or that of any other party, that the cap calculation should reflect NSA volumes but not the actual prices for those volumes.

[348] Order No. 26 at ¶ 2081.

Postal Service and the Commission from streamlining, updating, or otherwise modernizing the mail classification system to reflect the evolving postal marketplace. This requirement limited the Postal Service's pricing flexibility (objective 4 and factor 7), prevented changes that could have promoted simplicity and transparency (objective 6 and factor 6), hampered the ability to reflect changing demand trends and customer needs (factors 1, 4, and 8), and took options off the table for addressing the class-based price cap system's failures at allocative efficiency (objective 1 and factor 2). There are no apparent objectives or factors that it served, or that it continues to serve.

As early as 2011, the Commission recognized that this was a problem. In its first report under Section 701 of the PAEA, the Commission advised Congress that Section 3622(d)(2)(A) "significantly limits the Postal Service's flexibility" and recommended "explicitly allowing the Postal Service to add new classes of mail."[349] At that time, the Commission lacked the power to make such a change: a legislative solution was the only option. That is no longer the case: the Commission is no longer beholden to utilize the existing mail classes in the rate-regulation system.

In this proceeding, the Commission can and should therefore provide a procedural avenue in its rules for the Postal Service to propose, through an open and transparent process, the restructuring and modernization of mail classifications. The Postal Service should also be able to propose a full range of modernizations to the classification structure, from the movement of individual products between mail classes to a larger structural rationalization of mail classes. Doing so would give the Postal

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[349] Postal Regulatory Comm'n, Section 701 Report: Analysis of the Postal Accountability and Enhancement Act of 2006 (Sept. 22, 2011), at 41.

Service the flexibility to pursue changes to its product and rate structure in order to achieve its business goals and adapt to the changing marketplace.

VIII. CONCLUSION

The current system failed to achieve numerous statutory objectives. Although the Postal Service entered the PAEA era with positive net income and retained earnings, the price cap was not flexible enough to correct for declining economies of density or shifts in the Postal Service's pension and RHB expenses. As a result, the price cap has left the Postal Service with massive net losses and a dire liquidity position. This is the crux of the system's failure to achieve objectives 5 and 8. This also explains the current system's failure to provide adequate capital to invest in efficiency- and service-promoting infrastructure improvements, which would have furthered objectives 1 and 3. To correct these failings as Section 3622(d)(3) requires, any new system must give the Postal Service a meaningful opportunity to earn net income and generate surplus capital with which to improve efficiency, service quality, and mail security.

The proposal in Order No. 4258 does not offer such a remedy. It would perpetuate the lack of a mechanism to adjust for volume and cost trends beyond the Postal Service's control. The proposed supplemental rate authority would not even restore the Postal Service to a reasonable baseline level of net income. Nor would the proposed PIM offer much help: the Commission's TFP-benchmark/rolling-average methodology would keep most of that rate authority out of reach for the foreseeable future. To simply assume that unspecified cost savings can cure all of these ills, as Order No. 4258 does, ignores the statutory constraints that the Commission has itself recognized as well as the record evidence demonstrating that the amount of available cost savings within the Postal Service's control falls far short of the gap left by the Commission's proposal.

The Commission must solve these problems in order to fulfill its statutory obligation to design a system that will achieve the objectives. The simplest and most effective way to do this would be to adopt the proposal in the Postal Service's earlier comments. That proposal relies on the disciplinary forces of a challenging demand environment, coupled with robust regulatory monitoring and the threat of re-intervention. Six years of experience in the U.K., including a recent multi-year extension of the system, shows that this is an effective regulatory model in the current postal environment. Most importantly, it would achieve all of the statutory objectives.

If the Commission nevertheless remains committed to a price cap system in the near term, it must substantially revise its proposal in order to achieve the objectives. Best practices in rate regulation offer a number of guiding principles. Rates must be reset to reasonably compensatory levels. All supportable methods for calculating such a level indicate a new baseline much higher than that included in the Commission's proposal; the most appropriate method supports setting the supplemental rate authority at 4 percentage points. In addition, factors must be added to track known volume and cost trends beyond the Postal Service's control. And revenues for capital expenditures should be provided through a dedicated, unconditional mechanism. Otherwise, a number of fixes would be needed to make the performance-based rate authority realistically achievable and consistent with the goal of starting a "harmonious cycle."

Other practical changes would be needed to ensure that a new price cap system provides adequate pricing flexibility for the Postal Service to make responsible and market-responsive business decisions. Non-CPI-based rate authority should be made bankable, and the rules should not interfere unduly with the Postal Service's discretion as to the timing of price adjustments or with its pursuit of non-pricing remedies for underwater products. The price cap should also exclude inbound international rates outside the Postal Service's control, and NSA volumes should not be used to weight non-NSA products in the cap calculation. Finally, the Commission should provide an opportunity to modernize the mail classification system.